THE TAX POLICY CENTER'S

Briefing Book

A citizen's guide to the fascinating (though often complex) elements of the federal Tax System.

Overview

Introduction

During the 2016 presidential election campaign and well into the term of the next president, you will hear many confusing tax and budget terms. Who gets a repatriation tax holiday? What is a VAT? When is it the same as a flat tax? And how do corporations invert themselves anyway?

Ever wonder how candidates and elected officials seem to know so much about these obscure topics? It is because they have the advantage of a briefing book, a binder full of questions and answers prepared by their staffs that cover most every tax and budget topic.

This thoroughly updated version of the popular Tax Policy Center Briefing Book gives you a chance to level the playing field. It includes a wealth of information on those tax and budget issues that likely will be debated during the 2016 presidential election campaign and during the next president's term. Unlike those other briefing books, ours is for the public, the press, and anyone who wants to be well informed about current tax and budget matters.

WHAT IS THE BRIEFING BOOK?

The Tax Policy Center Briefing Book offers 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 does the budget process work? 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? Many entries examine how state and local governments raise funds and how their taxes interact with the federal tax system.

The candidates in the 2016 presidential race have proposed strikingly different ways to change the federal tax system, ranging from massive tax cuts to enormous tax increases. Evaluating these proposals requires a clear understanding of the complexity, fairness, and efficiency of the current tax system and the implications of proposed changes. Beyond the election, the same kind of analysis will help elevate the debate over fiscal policy changes that will be debated in the next administration and Congress.

HOW TO USE THE BRIEFING BOOK

The Tax Policy Briefing Book is not like other most other books: There is no beginning, middle, and end, and few readers will start with the first brief and read straight through to the last. Instead, you can pick a topic, read the basic information, and then follow the links to publications if you want to learn more. You may occasionally want to check online for new material as we will periodically expand and update the online book.

Overview

Introduction

HOW IS THE BRIEFING BOOK ORGANIZED?

The briefing book is organized into four topic areas: background, key elements of the US tax system, possible reforms, and state and local taxes. Links at the end of each entry take you to references containing additional information. The glossary provides definitions of many technical terms related to taxation and budgeting.

Background: discusses general aspects of the tax system.

Key Elements of the U.S. 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.

State (and Local) Taxes: examines how state and local governments raise funds to finance government services and other activities.

Glossary: defines many terms used in the briefing book.

ACKNOWLEDGEMENTS

The Tax Policy Briefing Book: A Citizens' Guide to the Tax System and Tax Policy is the result of many people's efforts. In addition to the authors listed below, certain people deserve special credit for their roles in bringing the current briefing book to fruition. Len Burman conceived the briefing book and laid out its basic structure. Peter Passell, Fiona Blackshaw, Elizabeth Forney, David Hinson, and Michael Marazzi edited the entries. Joey Teitelbaum and Elena Ramirez, with assistance from Lydia Austin, coordinated the project and created all of the graphs and tables. Rynnel Laughlin and Yifan Zhang posted the entries and set up the web links. Frank Sammartino reviewed each entry and oversaw the book's content and organization.

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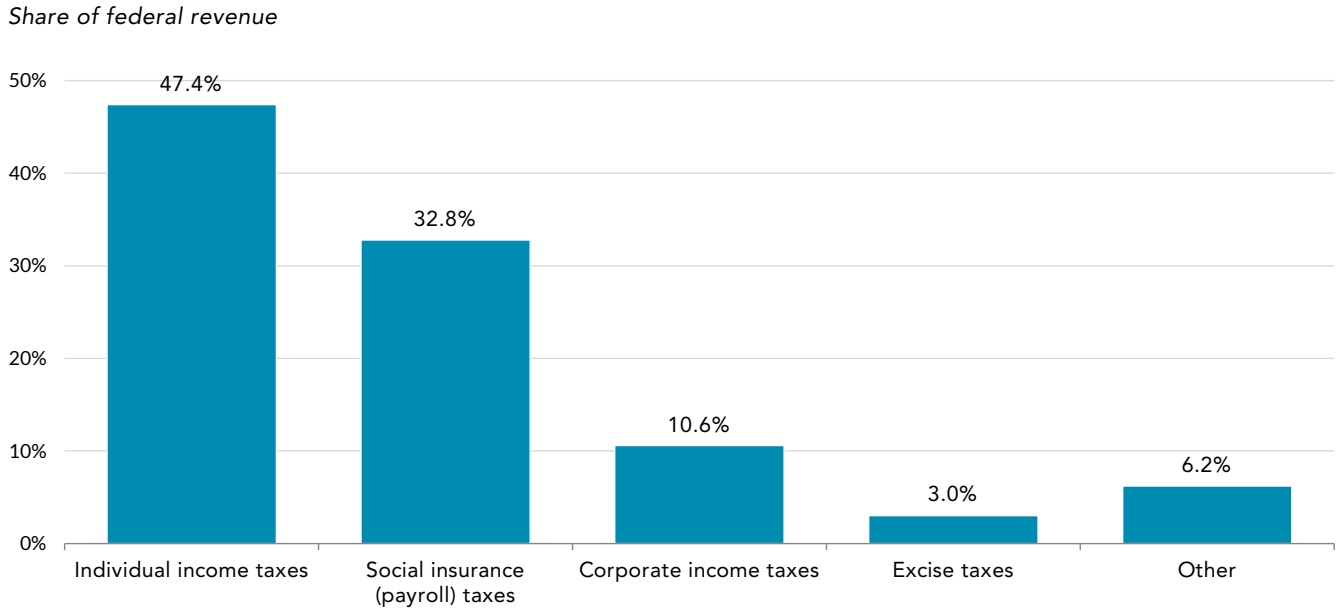
Q. What are the sources of revenue for the federal government?

A. Roughly 80 percent comes from the individual income tax and the payroll taxes that fund social insurance programs (figure 1). Another 11 percent comes from the corporate income tax, and the rest is from a mix of sources.

FIGURE 1

Sources of Total Federal Tax Revenue
FY2015



Source: Office of Management and Budget, Fiscal Year 2017, Historical Tables, Table 2.1.

TOTAL REVENUES

In fiscal year (FY) 2015 the federal government collected revenues of $3.2 tril-lion—about 18.3 percent of GDP. Over the past 50 years, federal revenue has av-eraged 17.4 percent of GDP, ranging from 20.0 percent (in 2000) to 14.6 percent (most recently in 2008 and 2009).

Background

What are the sources of revenue for the federal government?

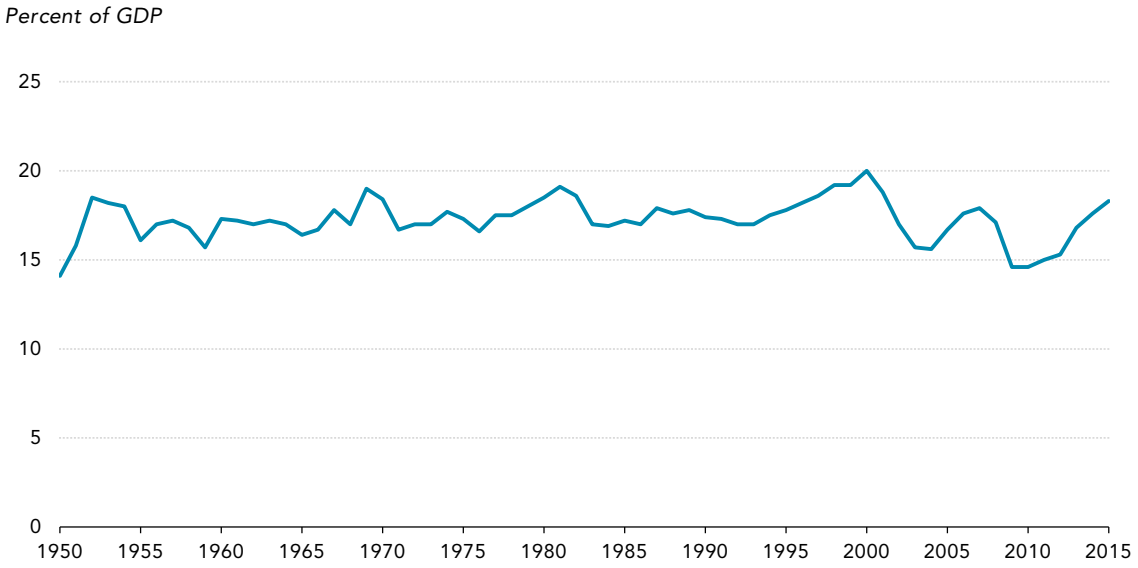
INDIVIDUAL INCOME TAX

The individual income tax has been the largest single source of federal revenue since 1950, amounting to 47 percent of the total and nearly 9 percent of gross domestic product (GDP) in 2015. In recent years, individual income tax revenue has climbed as high as 9.9 percent of GDP (in 2000) at the peak of the 1990s economic boom and dropped as low as 6.1 percent (in 2010) following the 2007-2009 Great Recession.

FIGURE 2

Total Federal Receipts as a Share of National GDP

1950-2015



Source: Office of Management and Budget, Fiscal Year 2017, Historical Tables, Table 2.3.

PAYROLL TAXES

The payroll taxes on wages and earnings that fund Social Security and the hospital insurance portion of Medicare make up the largest portion of social insurance re-ceipts. Other sources include payroll taxes for the railroad retirement system and the unemployment insurance program and federal workers' pension contributions. All told, social insurance levies represented 32.8 percent of federal revenue in 2015.

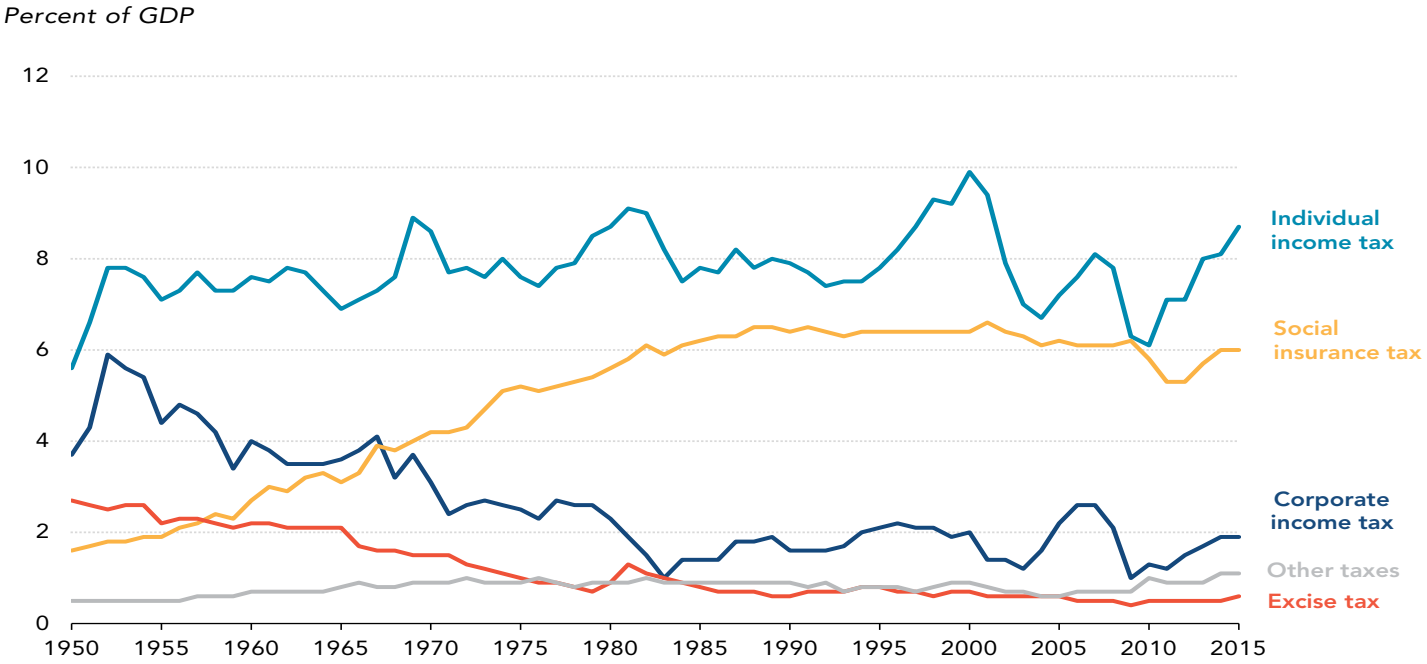
The creation of the Medicare program in 1965, combined with periodic increases in Social Security payroll taxes, caused social insurance receipts to grow from 1.6 percent of GDP in 1950 to 6.2 percent in 2009. A temporary reduction in employ-ees' share of Social Security taxes—part of the stimulus program following the fi-nancial meltdown—reduced social insurance receipts to 5.3 percent of GDP in 2011 and 2012. They reached 6 percent of GDP in 2014 and 2015.

Background

What are the sources of revenue for the federal government?

FIGURE 3

Federal Receipts by Source as a Share of National GDP
1950-2015



Source: Office of Management and Budget, Fiscal Year 2017, Historical Tables, Table 2.3.

CORPORATE INCOME TAX

The tax on corporate profits yielded 10.6 percent of government revenue in 2015, a revenue source that has been trending downward. Revenue from the tax has fallen from an average of 3.7 percent of GDP in the late 1960s to an average of just 1.6 percent of GDP over the past five years, despite ticking up to 1.9 percent of GDP in 2014 and 2015.

FEDERAL EXCISE TAXES

Taxes on purchases of a mélange of goods and services, including gasoline, ciga-rettes, alcoholic beverages, and airline travel, generated 3 percent of federal rev-enue in 2014. But these taxes, too, are on the wane: ex-cise tax revenues have fall-en steadily from an average of 1.7 percent of GDP in the late 1960s to an average of 0.5 percent over 2011-15.

OTHER REVENUES

The federal government also collects revenue from estate and gift taxes, customs duties, earnings from the Federal Reserve System, and various fees and charges. Total, these sources generated 6.2 percent of federal revenue in FY 2015. They have averaged between 0.6 and 1.1 percent of GDP since 1965. In recent years, the figure has been on the high end of that range because of unusually high profits of the Federal Reserve Board related to its efforts to stimulate the economy since 2008.

Background

What are the sources of revenue for the federal government?

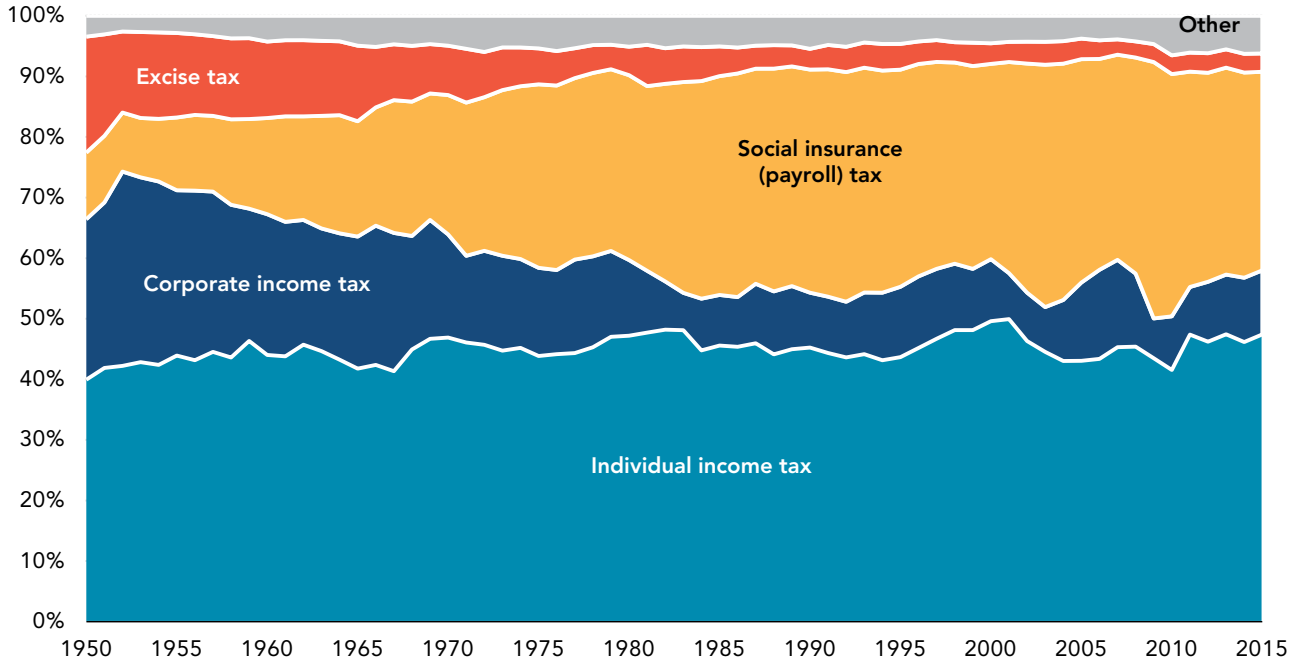
CHANGES OVER TIME

The individual income tax has provided nearly half of total federal revenue since 1950, while other revenue sources have waxed and waned. Excise taxes brought in 19.0 percent of total revenue in 1950, but only about 3.0 percent in recent years. The share of revenue coming from the corporate income tax dropped from about a third of the total in the early 1950s to just over a tenth in 2015. In contrast, pay-roll taxes provided a third of revenue in 2015, more than three times the share in the early 1950s.

FIGURE 4

Sources of Federal Revenue

FY 1950-2015



Source: Office of Management and Budget, Fiscal Year 2017, Historical Table 2.1.

[1] All years in entry are fiscal years.

Data Sources

Office of Management and Budget. Budget of the United States Government, Fis-cal Year 2017, Historical Tables. Table 2.1. "Receipts by Source: 1934–2021" and Table 2.3. "Receipts by Source as Percentages of GDP: 1934–2021."

Further Reading

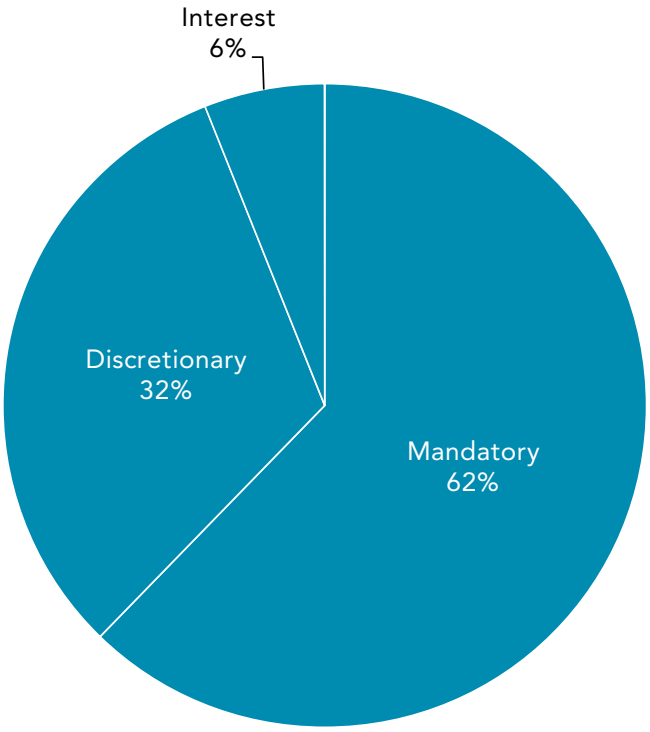
Joint Committee on Taxation. 2016. Overview of the Federal Tax System as in Ef-fect for 2016. JCX-43-16. Washington, DC: Joint Committee on Taxation.

Q. How does the federal government spend its money?

A. In fiscal year (FY) 2015, about 62 percent of federal spending paid for programs not subject to regular budget review, while nearly a third covered discretionary programs for which Congress must regularly appropriate funds. Six percent went for interest on government debt (figure 1).

FIGURE 1

Composition of Total Federal Spending
FY2015



Source: Congressional Budget Office, Updated Budget Projections: 2016 to 2026, March

Background

How does the federal government spend its money?

MANDATORY SPENDING

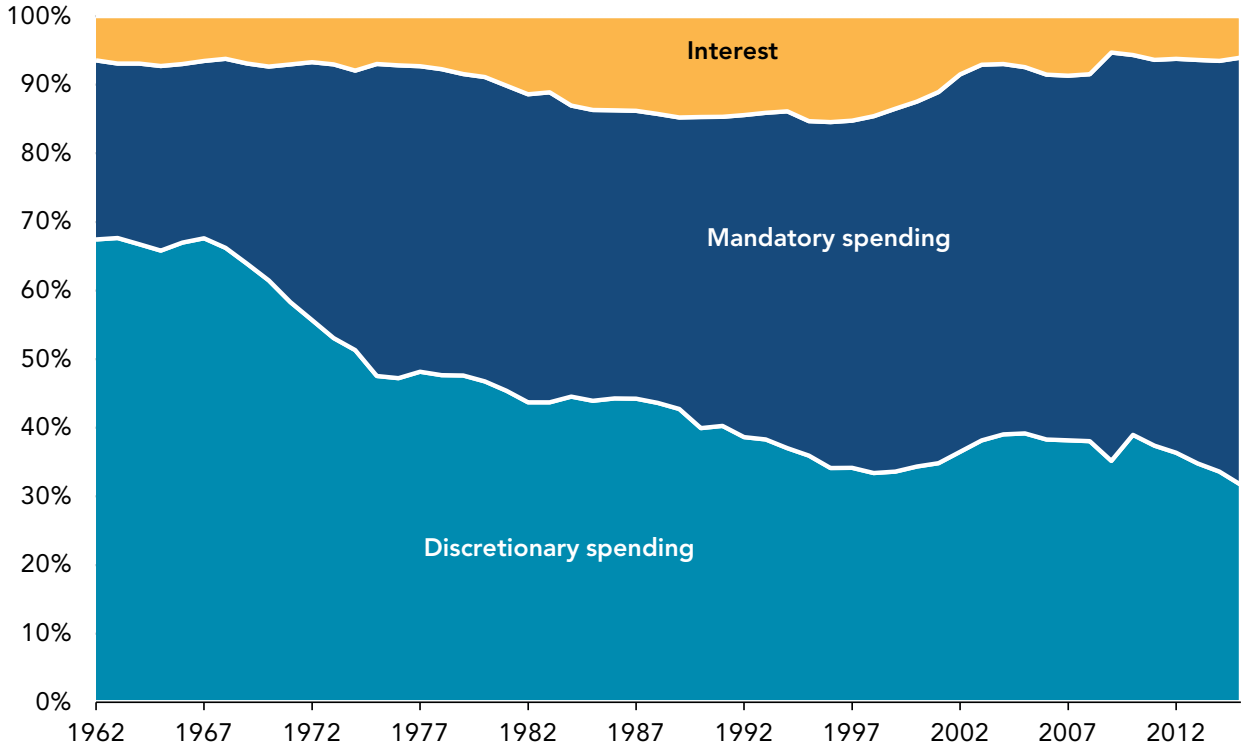
Mandatory spending covers outlays that are controlled by laws other than appro-priations acts. Almost all such spending is for "entitlements," for which expendi-tures depend on individual eligibility and partici-pation; they are funded at whatev-er level is needed to cover the resulting costs. Mandatory spending has grown from about a quarter of the budget in 1962 to 60 percent in 2015 (figure 2). This is in large part be-cause of new entitlements, including Medicare and Medicaid (both of which started in 1965), the earned income tax credit (1975), and the child tax credit (1997). In addition, rapid growth of both the elderly and disabled popula-tions has contributed to increased Social Security and Medicare spending.

FIGURE 2

Federal Spending by Type

FY1962-2015

Share of federal budget



Source: Office of Management and Budget, Fiscal Year 2017, Historical Tables: Table 8.1.

Background

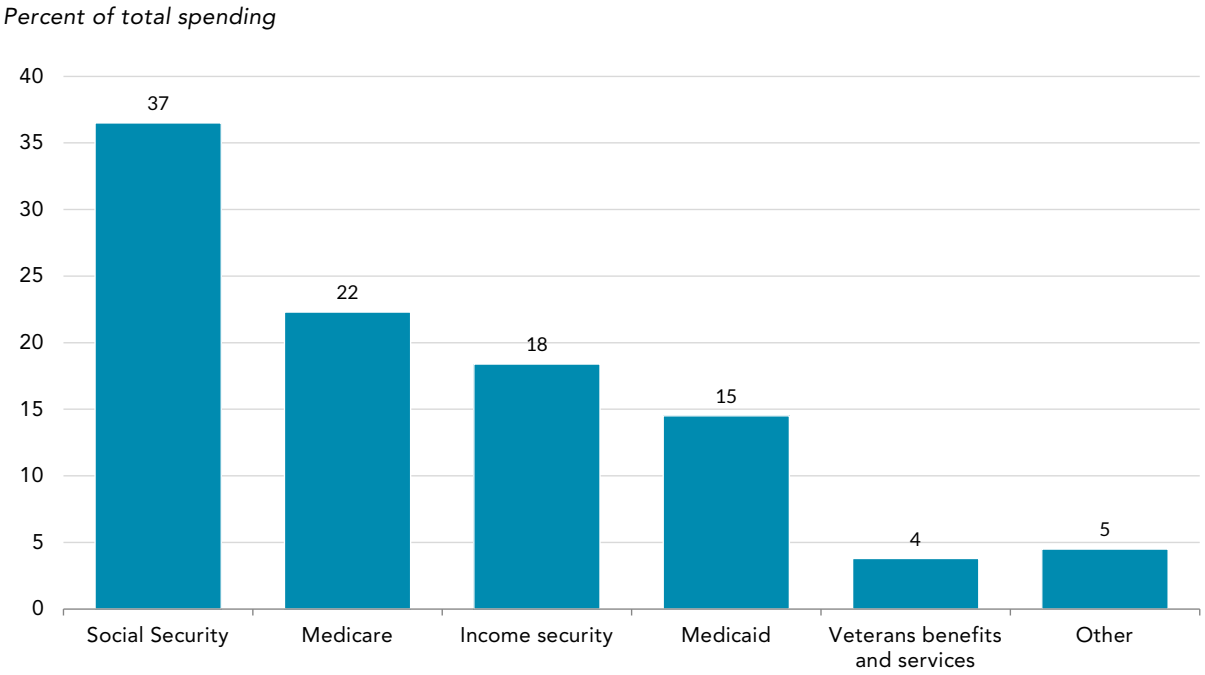
How does the federal government spend its money?

Nearly 60 percent of mandatory spending in 2014 was for Social Security and other income support programs (figure 3). Most of the remainder paid for the two major government health programs, Medicare and Medicaid.

FIGURE 3

Composition of Total Mandatory Spending

FY2015



Source: Office of Management and Budget, Fiscal Year 2017, Historical Tables, Table 8.5.

DISCRETIONARY SPENDING

Discretionary spending covers programs that require appropriations by Congress. Unlike mandatory spending, both the programs and the authorized levels of spending require regular renewal by Congress. The share of the budget going for discretionary spending has fallen from two-thirds in 1962 to about one-third now.

About half of FY 2015 discretionary spending went for defense, and most of the rest for domestic programs, including agricultural subsidies, highway construction, and the federal courts (figure 4). Only 4 percent of discretionary spending funded international activities, such as foreign aid.

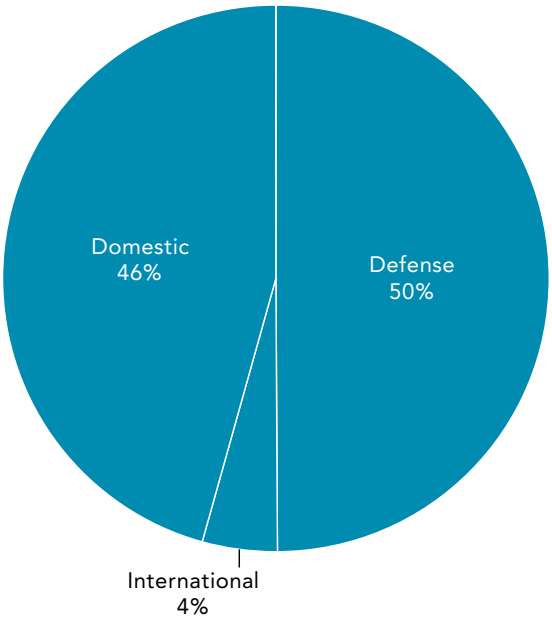
Background

How does the federal government spend its money?

FIGURE 4

Composition of Total Discretionary Spending

FY2015



Source: Office of Management and Budget, Fiscal Year 2016, Historical Tables, Table 8.7.

DEBT SERVICE

Interest on the national debt has fluctuated over the past half century along with the size of the debt and interest rates. It climbed from 6 percent of gross domestic product (GDP) in 1962 to more than 15 percent in the mid-1990s, fell to about 7 percent in the early 2000s, and has fallen even more recently, as interest rates have tumbled to historically low levels. While the national debt reached a peacetime high of 74 percent of GDP in 2014 and dipped just under that level in 2015, debt service accounted for just 6 percent of federal spending in 2015.

Data Sources

Congressional Budget Office. Budget and Economic Outlook: Fiscal Years 2016 to 2026, Historical Budget Data.

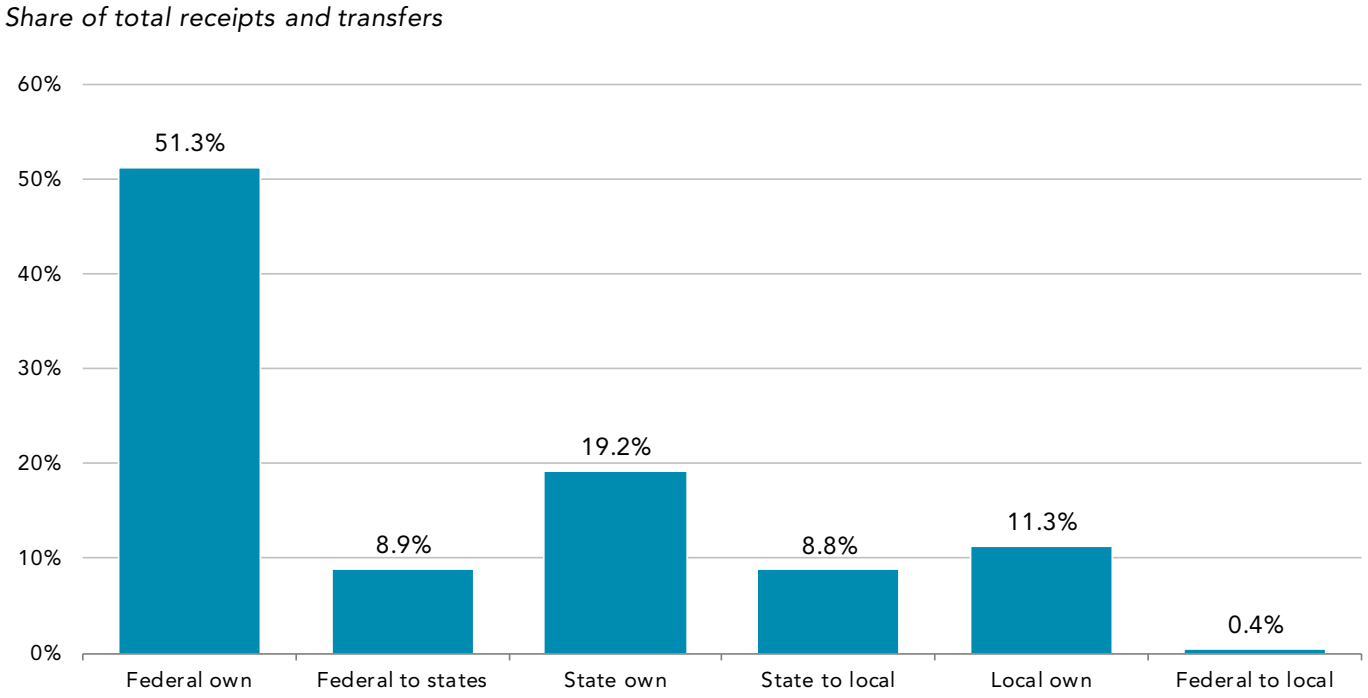
Office of Management and Budget. Budget of the United States Government, Fis-cal Year 2017, Historical Tables. Table 7.1. "Federal Debt at the End of Year: 1940–2021"; Table 8.1. "Outlays by Budget Enforcement Act Category: 1962–2021"; Table 8.5. "Outlays for Mandatory and Related Programs: 1962–2021"; and Table 8.7. "Outlays for Discretionary Programs: 1962–2021."

Q. WHAT IS THE BREAKDOWN OF REVENUES AMONG FEDERAL, STATE, AND LOCAL GOVERNMENTS?

A. In 2015, federal revenue made up about 61 percent of the $5.7 trillion total, while states collected about 28 percent, and local governments brought in about 11 percent (figure 1).

FIGURE 1

Federal, State, and Local Government Receipts and Transfers
2015



Background

What is the breakdown of tax revenues among federal, state, and local governments?

The federal government collected about $3.4 trillion in 2015. It transferred about $508 billion to states and $23 billion to local governments, leaving it with roughly $2.9 trillion. States collected about $1.6 trillion that same year.
States received $508 billion from the federal government and gave about $500 billion to local governments, leaving about $1.6 billion available for spending.
Local governments collected nearly $650 billion in 2015, giving them roughly $1.2 trillion after adding what they received from state and federal transfers.

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.

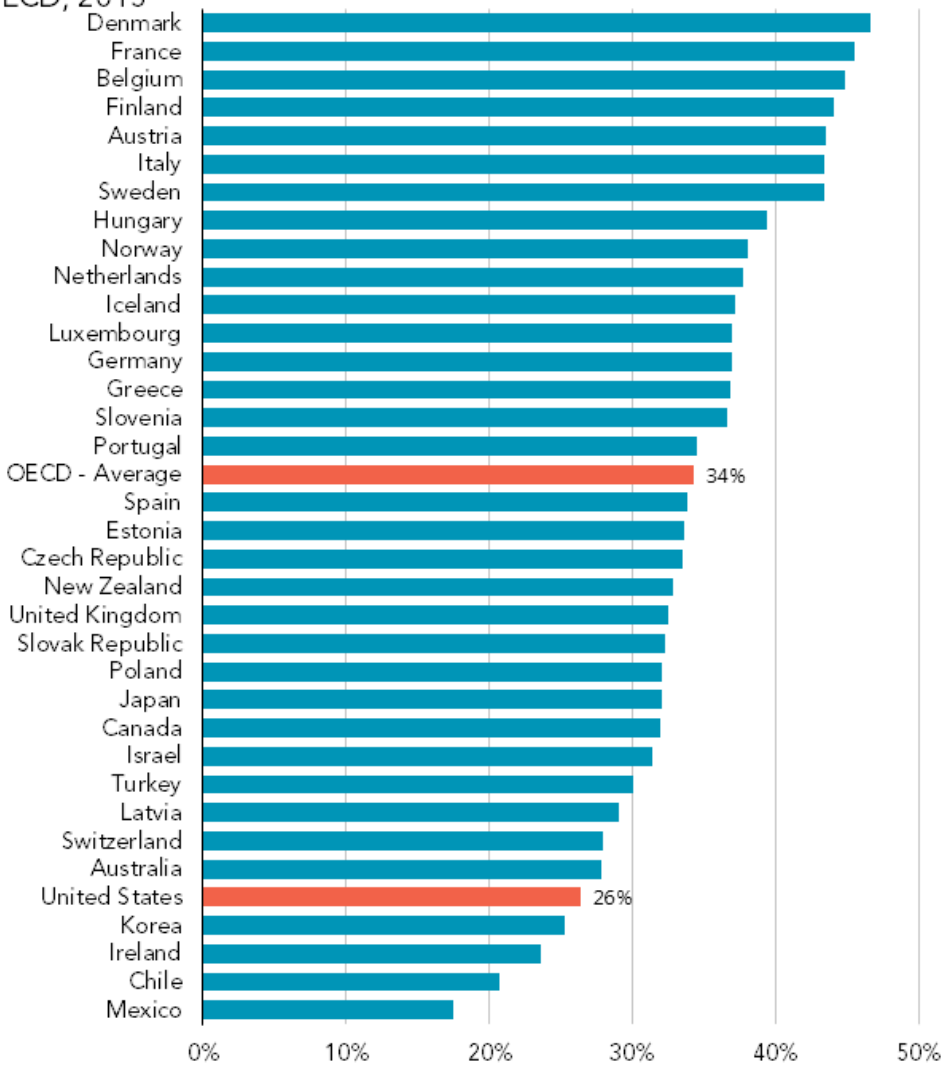
Q. How do US taxes compare internationally?

A. Total US tax revenue equaled 26 percent of gross domestic product (GDP), well below the 34 percent average for developed countries (figure 1).

FIGURE 1

Taxes as a Share of Gross Domestic Product

OECD, 2015



Source: OECD Stat Extract. These are provisional estimates. 2014 data are used for Australia, Japan, and Poland. The OECD average is over the most recent available data.

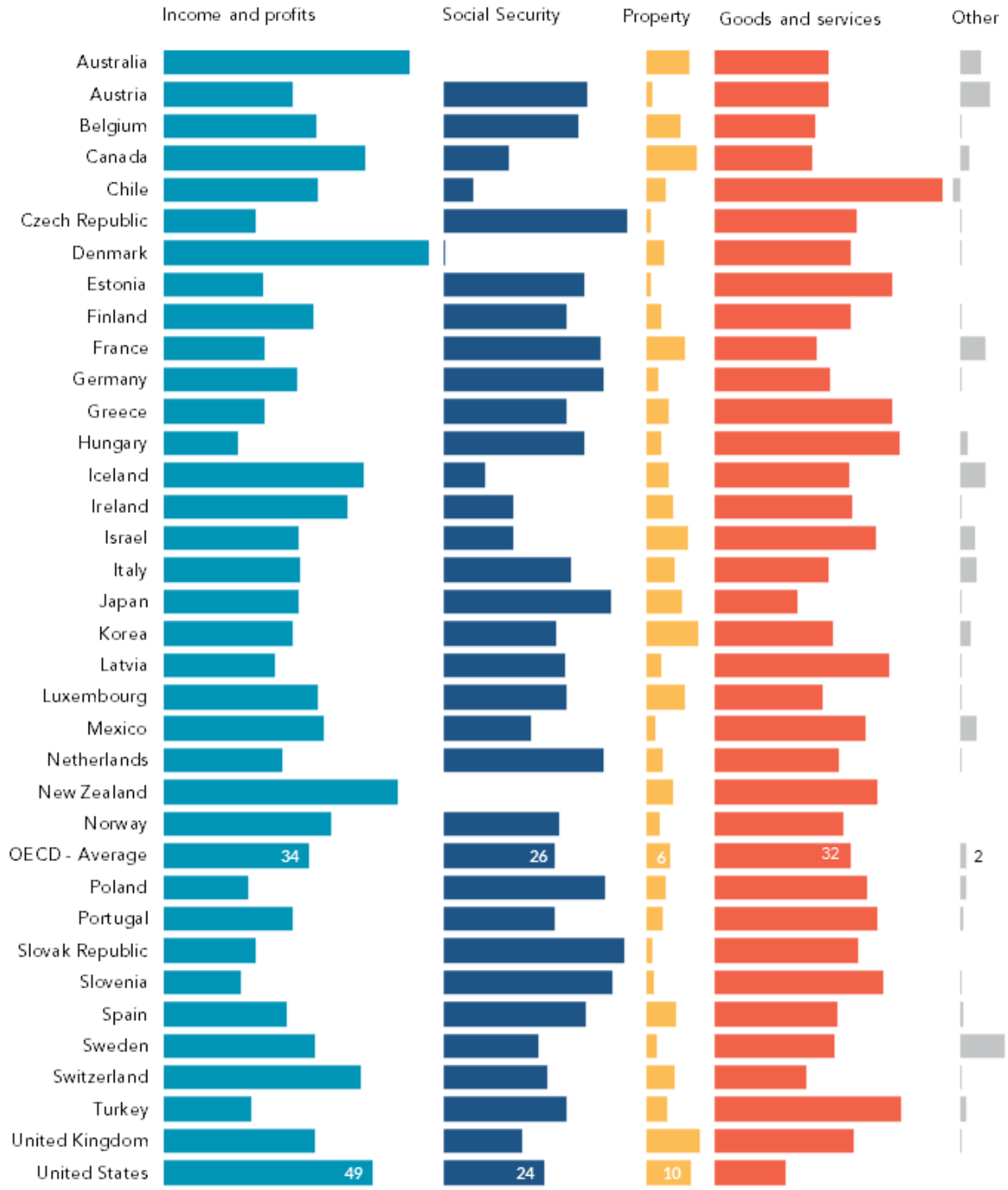
Background

How do US taxes compare internationally?

FIGURE 2

Taxes by Source as a Share of Total Tax Revenues

Among OECD countries, 2015



Source: OECD Stat Extract.

Notes: Other taxes include payroll taxes not classified as Social Security contributions. These are provisional estimates. 2014 Data used for Australia, Japan, Mexico, and Poland. The average is over the most recent estimates.

Background

How do US taxes compare internationally?

TOTAL TAX REVENUE

US taxes are low relative to those in other developed countries. In 2015, US taxes at all levels of government represented 26 percent of GDP, compared with an average of 34 percent of GDP for the 34 member countries of the Organisation for Economic Co-operation and Development (OECD).

Among OECD countries, only Korea, Chile, Mexico, and Ireland collected less than the United States as a percentage of GDP. In many European countries, taxes exceeded 40 percent of GDP. But those countries generally provide more extensive govern-ment services than the United States does.

COMPOSITION OF TAX REVENUE

Income and Profits Taxes: Taxes on personal income and business profits made up 49 percent of US tax revenue in 2015, a higher percentage than in most other OECD countries, where such taxes averaged 34 percent of the total (figure 2). Australia, Denmark, and New Zealand topped the United States in this category, generating over half of their total revenue from such taxes. In the United States, personal income taxes alone generated 40 per-cent of total tax revenue compared with 24 percent on average within the OECD.

Social Security Contributions: The United States collects relatively less revenue dedicated to retirement, disability, and other social security programs—24 percent of total tax revenue—than the 26 percent OECD average. Some countries were well above that average: the Slovak and Czech Republics, Slovenia and Japan all collected 40 percent or more of their revenue from that source.

Property Taxes: Property taxes provided almost twice as large a share of US tax revenue—10 percent in 2015—than the OECD average of 6 percent. Almost all revenue from taxes on property in the United States is collected by state and local governments.

Goods and Services Taxes: The United States relies less on taxes on goods and services (including both general consumption taxes and taxes on specific goods and services) than any other OECD country, collecting 17 percent of tax revenue this way compared with 32 percent for the OECD. The value-added tax (VAT)—a type of general consumption tax collected in stages—is the main source of consumption tax revenue, employed worldwide in 160 countries including all 34 OECD member countries except the United States. Most consumption tax revenue in the United States is collected by state and local governments.

Data Sources

Organisation for Economic Co-operation and Development. OECD Tax Statistics, 2015. "Revenue Statistics: Comparative Tables."

Organisation for Economic Co-operation and Development. 2014. "Consumption Tax Trends 2014."

Further Reading

Hoo, Sonya, and Eric Toder. 2006. "The U.S. Tax Burden Is Low Relative to Other OECD Countries." Tax Notes. May 8.

Background

How does the federal budget process work?

Q. How does the federal budget process work?

A. Ideally, following submission of the president's budget proposal, Congress passes a concurrent budget resolution setting total spending, revenue, and deficit targets for at least the next five years, and then passes annual appropriation bills to fund discretionary programs and legislation to enact changes to mandatory programs and taxes. The process has typically broken down at various points in recent years, however, with Congress failing to pass a concurrent resolution or completing action on appropriations.

THE PRESIDEN'TS BUDGET

The congressional budget process begins each year with the president submitting a budget for the following fiscal year. The president's budget proposes spending levels for federal programs whose funding is determined annually (discretionary programs) and may recommend policy changes to ongoing programs that do not require annual appropriations (mandatory programs) and to the tax code.

CONGRESSIONAL BUDGET RESOLUTION

Within the six weeks following submission, the various congressional committees report to the House and Senate budget committees outlining how their spending and revenue proposals will differ from the president's budget. After each budget committee compiles this information, Congress is required to pass a concurrent budget resolution setting out total spending, revenue, and deficit targets for at least the next five years. Concurrent resolutions are endorsed by both the House and the Senate, yet lack the force of law and do not require the president's signature—which, of course, implies that the president cannot veto them, either.

The budget resolution divides total spending among the main functions of government, such as defense, transportation, and health, through spending allocations to individual congressional committees. The House and Senate appropriations committees further divide their spending allocations among their subcommittees. The budget resolution allows individual congressional committees to decide the details of their budgets, program by program, consistent with the aggregate targets. In practice, however, the debate over the resolution often becomes a debate over individual program budgets and their implications.

Background

How does the federal budget process work?

The Senate and the House have not always successfully hammered out a single budget resolution. In early 2015, they agreed to a resolution for fiscal 2016—the first time they'd been successful since fiscal 2010. However in 2016, they again failed to pass a resolution for fiscal 2017.

Even when they pass a resolution, the Congress frequently violates the resolution's spending and revenue targets. Nevertheless, economists believe that the resolution exerts some discipline over tax and spending policy.

APPROPRIATIONS PROCESS

After the budget resolution passes, the House Appropriations Committee may begin the appropriations process. If a budget resolution is not passed by May 15, the House Appropriations Committee may begin appropriations in its absence. There are 12 appropriations bills covering different parts of the government. Agencies that are not funded because their appropriations have not been passed by October 1 are funded under continuing resolutions. These typically cover spending for only part of a year but Congress sometimes extends them to cover the whole fiscal year. Continuing resolutions often limit spending to last year's level. Recently, it has become more common for no appropriation bills to pass by October 1. Then the government is funded by an extremely complicated omnibus bill. This makes it difficult for legislators to implement a rational set of national priorities.

THE CONGRESSIONAL BUDGET OFFICE

The Congressional Budget Office (CBO) provides the Congress with technical, nonpartisan advice on budget matters. Every bill Senate and House committees report to the floor must include a CBO cost estimate that covers at least five years (and more recently, 10 years) to show whether the proposed spending matches the budget resolution targets.

RECONCILIATION

Congress occasionally uses a special procedure called reconciliation to fast-track revenue and entitlement spending legislation. The Budget Resolution instructs committees to implement certain targets for changing revenues and expenditures. The resulting reconciliation bill combines spending and revenue provisions into a single piece of legislation. Debate is limited and the bill cannot be filibustered in the Senate. The Senate cannot use reconciliation to increase the deficit, but the House can use it to reduce revenues.

Further Reading

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Joyce, Philip. 2014. "Budgetary and Fiscal Policy." In *Public Economics in the United States*, vol. 2, edited by Steven Payson, 699–722. Santa Barbara, CA: Praeger.

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Q. What is the history of the federal budget process?

A.In 1972, President Richard Nixon impounded funds for various social programs. Nixon argued that because Congress lacked a process for controlling the overall federal budget, budget deficits might expand irresponsibly if the president lacked the power to block funding. Congress responded by establishing a formal budget process through the Congressional Budget and Impoundment Control Act of 1974.

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 procedure for Congress's revenue and spending decisions, and to constrain a president's ability to impound funds appropriated by Congress.

In 1972, newly reelected President Richard Nixon refused to spend funds appropriated 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 was obliged to spend every dollar appropriated.

Prospective recipients quickly challenged Nixon's impoundments 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 irresponsibly.

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.

There was no way to take the politics out of politics, however: The designers of the new process were intent on avoiding any significant reduction in the powers of existing committees. With a few exceptions, the new budget process only established targets for aggregate spending and revenue totals. Traditional committees were left to determine the details. This compromise made the new process much more complicated than it

Background

What is the history of the federal budget process?

would otherwise have been.

The budget process has evolved since. Originally, two budget resolutions were required; now, only one. Reconciliation was originally seen as a mechanism for reconciling the first budget resolution with the second. Now it is a mechanism for expediting changes in entitlements and tax policy.

Further Reading

Schick, Allen. 1995. *The Federal Budget: Politics, Policy, Process.* Washington, DC: Brookings Institution Press.

Background

What is the schedule for the federal budget process?

Q. What is the schedule for the federal budget process?

A. The congressional budget process is meant to last from early February to the end of June, but recent years have seen delays at each stage, particular in passing congressional budget resolutions and in completing action on appropriation bills.

The congressional budget process begins each year with the president submitting a budget for the following fiscal year. Usually, Congress receives the budget no later than the first Monday in February. The whole procedure is supposed to be completed by June 30, but that almost never happens.

Within the six weeks following submission, the various congressional committees report to the House and Senate budget committees, outlining how their spending and revenue proposals will differ from the president's budget. After each budget committee compiles this information, Congress is supposed to pass a concurrent budget resolution by April 15.

From fiscal 1976 (the first effective year of the budget process) through 1998, Congress successfully passed budget resolutions each year. Failure to pass a budget resolution has recently become more common, however. Indeed, the longest period without a budget resolution passed by the whole Congress lasted from fiscal 2011 through fiscal 2015.

After the budget resolution passes, the House Appropriations Committee may begin the appropriations process. If a budget resolution is not passed by May 15, the House Appropriations Committee may begin appropriations in its absence. All necessary appropriations bills are supposed to be passed by June 30 but seldom are.

Congress occasionally uses a special procedure called reconciliation to fast-track revenue and spending legislation. Reconciliation bills are supposed to be complete by June 15.

If appropriations are not complete by October 1—and that is common—federal agencies are funded under continuing resolutions. These typically cover spending for only part of a year but Congress sometimes extends them to cover the whole fiscal year. Continuing resolutions often limit spending to last year's level.

Further Reading

Schick, Allen. 1995. *The Federal Budget: Politics, Policy, Process.* Washington, DC: Brookings Institution Press.

Stone, Chad. 2014. "The Federal Budget Process." In Public Economics in the United States, vol. 2, edited by Steven Payson (679–98). Santa Barbara, CA: Praeger.

Q. What is reconciliation?

A. Congressional budget committees use the reconciliation process to ensure tax laws and mandatory spending programs are revised according to the budget resolution's revenue and spending targets. The reconciliation process is a way to fast-track revenue and spending legislation into becoming law.

Reconciliation legislation is passed through an expedited process. First, Congress passes a budget resolution containing "reconciliation instructions" telling congressional committees how much they need to change their revenue and spending to conform to a new budget resolution. The committees' responses are then bundled by the House and Senate budget committees into a single reconciliation bill for consideration in each chamber.

Reconciliation bills are subject to special rules in the Senate. Debate on reconciliation bills is limited to 20 hours. If the law is free of points of order, it can be passed in the Senate by a simple majority; the 60 votes necessary to shut off a filibuster are not required. Any member, however, can raise a point of order against a reconciliation bill if it violates the spending and revenue targets in the budget resolution or other budget rules and laws. Sixty votes are needed to overcome a point of order. The House can set procedural rules on any legislation, including reconciliation bills, by adopting a special "rule" determined by the House Rules Committee. Debate is limited in the House to whatever time the Rules Committee allows.

The George W. Bush tax cuts were passed using reconciliation procedures. During the short time that they controlled both houses of congress, Democrats reacted by passing new rules that prevented reconciliation from being used to increase the deficit. After Republicans again took over, they repealed those rules, so that reconciliation can now be used to reduce revenues, but not to increase entitlement spending. The content of reconciliation laws is limited in the Senate by the Byrd rule, which generally disallows items that do not affect outlays or revenue. The Byrd rule also prohibits initiatives that would increase the deficit beyond the fiscal years covered by the budget resolution.

EXAMPLES

Policymakers have passed 20 budget reconciliation bills since they first used the procedure in 1980. In 2001, for example, the Senate could not muster the 60-vote super-majority necessary to pass the Bush tax cuts so it passed the legislation instead as a reconciliation bill with 58 yea votes. However, to avoid abrogating the Byrd rule, which disallows bills that increase the deficit beyond the budget resolution's window, the tax cuts were scheduled to expire after ten years.

Background

What is reconciliation?

More recently, the Congress used reconciliation to pass the Health Care and Education Reconciliation Act of 2010. This bill was responsible for various student loan reforms and changes to the Patient Protection and Affordable Care Act, which was signed into law 7 days earlier.

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Q. How is a budget resolution enforced?

A. 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 calculating whether the targets are being met. A House or Senate member may raise a point of order against a bill or an amendment if it violates spending and revenue levels as contained in the most recent budget resolution or if it violates other budget laws and rules. If a point of order is sustained, the bill or amendment is ineligible for consideration

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

The House Rules Committee also determines what amendments can be offered during the budget resolution debate. Because the Rules Committee has immense power, the House Budget Committee has less influence in enforcing the budget resolution than its Senate counterpart.

In the Senate, if a point of order is lodged against a bill or an amendment, a super-majority vote of 60 senators is needed to overcome it. The chair 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 withdrawing the threatened point of order.

Q. How is a budget resolution enforced?

A. 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.

OVERVIEW

PAYGO, which stands for "pay-as-you-go," is a budget rule requiring that (using current law as the baseline) tax cuts as well as increases in entitlement and other mandatory spending must be covered by tax increases or cuts in mandatory spending. It does not apply to discretionary spending (spending that is controlled through the appropriations process).

HISTORY

The original PAYGO was part of the Budget Enforcement Act of 1990. In that year, President George H. W. Bush and congressional leaders painfully negotiated a large deficit reduction package combining spending cuts and tax increases. Having accomplished so much, Congress became concerned that future Congresses would reverse the agreement bit by bit. PAYGO helped prevent this, supplemented by caps on appropriations and outlays for discretionary spending programs. Budget experts generally agree that PAYGO worked extremely well from 1990 through 1997. In 1998, an unexpected budget surplus emerged and the discipline driven by PAYGO began to wane. The law officially expired at the end of fiscal 2002.

RECENT VERSIONS

The most recent version of the PAYGO rule was established in 2010: To the extent that legislation does not pay for increases in mandatory spending or for tax cuts, the cumulative amount of the projected increase in the deficit is averaged over two periods—5 years and 10 years. (Budget imbalances in the current budget year are included, so in practice the averaging is over six and 11 years.) To prevent manipulation of the pay-go rules, legislation subject to PAYGO cannot move costs outside the budget window (i.e., after 10 years) or move saving into the budget window from later years.

Background

What is PAYGO?

SEQUESTRATION

If the Office of Management and Budget determines that either the 5- or 10-year average cost is great then zero when Congress adjourns, the President must sequester (apply an across-the-board spending cut) certain mandatory spending programs. The higher of the two averages determine the sequestered amount. Spending for each program is reduced by the same percentage for one year to offset the average projected deficit. Unless Congress acts to reduce or eliminate the project deficit increase, there is another sequestration the following year.

Some programs are exempt from sequestration. Social Security and the postal service are exempt because they are classified as "off-budget" programs (although they are included in consideration of the unified budget). Moreover, numerous welfare and other safety net programs, such as Medicaid, the Supplemental Nutrition Assistance Program (SNAP) and unemployment insurance, also are exempt. Medicare is subject to sequestration, but the spending reduction for Medicare is limited to 4 percent. If sequestration calls for an across-the-board reduction of more than 4 percent, the additional amount that would have come from Medicare is allocated proportionally to other programs.

ENFORCEMENT

The PAYGO rule has not been enforced consistently. For example, the 1997 Budget Act put in place a method, known as the SGR (the sustainable growth rate), for determining Medicare payments to physicians. Application of that formula threatened huge cuts in Medicare physician reimbursements. Congress prevented the payment rates determined by SGR from taking effect, but only for one year at a time. While Congress did pay for these one-year fixes, by limiting the fix to one year it did not need to pay the cost of the fix over the full budget window. When the Medicare Access and CHIP Reauthorization Act of 2015 replaced the SGR formula with a new system in 2015, Congress waived the PAYGO rules, exempting itself from paying for the entire cost of the new legislation.

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Q. How accurate are long-run federal budget projections?

A. Some elements of spending—health care costs and interest on the federal debt—are difficult to predict. But even in the best scenarios, the debt will remain a significant problem.

The Congressional Budget Office (CBO) has been making periodic long-run budget projections since the 1990s. Since then, policies have changed—as have economic and demographic assumptions underlying the analysis. But the lesson from these projections has remained the same: The United States is on an unsustainable fiscal path. That is to say, if policies are not reformed, the public debt will grow until no prudent investor will buy US Treasury securities.

The most important underlying cause of our public debt is population aging. The result is pressure on Social Security, the largest program in the budget, and on Medicare and Medicaid, the largest health insurance programs. Aging is easy to forecast because life expectancy has increased steadily and current age demographics are well known. More difficult to forecast are birth rates and growth of the taxpaying population, but birth rates have remained low for a long time with no surprises.

Per person health costs have risen faster than incomes, after adjusting for the population aging that has driven the projected rise in total spending. But this "excess cost growth" is difficult to forecast. After constituting most total health cost growth for decades, it slowed abruptly in the 2000s. And no one knows whether the slowdown will last or will be a one-time phenomenon.

Structural changes in the delivery of health care may hold down cost growth in the long run. On the other hand, excess cost growth might resume at historically familiar rates. In recent long-run projections, CBO has assumed that excess cost growth will indeed resume, but at a rate lower than the historical average.

Another uncertainty stems from the difficulty of forecasting the interest bill on the debt. Because of the Great Recession, the stimulus program, and relatively slow growth since, the debt-GDP ratio has risen from 35.2 percent in 2007 to 74.1 percent in 2014. That ratio is expected to decline slightly for a few years, but its magnitude makes long-run budget projections sensitive to assumptions about future interest rates. If deficits and the interest rate grow significantly in the long run, interest on the debt will spiral and become a major part of the debt/deficit problem.

Since the Great Recession, interest rates have remained extremely low relative to historical norms. CBO's long-run projections assume an increase but not a return to historical averages. If interest rates do rise more than CBO assumes, the long-run budget outlook becomes more problematic.

Background

How accurage are long-run federal budget projections?

On the other hand, if interest rates stay low and excess health costs grow less than CBO assumes, it is possible to construct plausible scenarios in which the debt-GDP ratio does not rise much. But an actual long-run decline in the ratio is highly unlikely because the aging population will drive growth of key spending programs. Many analysts argue that the ratio staying over 70 percent would be dangerous—it would reduce confidence in the government's commitment to pay its debts, even as chronic deficits "crowded out" productivity-enhancing private investment. A recession accompanied by a stimulus program or a war could push the ratio above 100 percent in the blink of an eye.

The bottom line: health costs and the interest bill on the debt are more unpredictable than they seemed early in the 21st century. But the range of uncertainty is from a bad situation that may have stabilized to a bad situation that evolves into a nightmare. The uncertainty has not eliminated the need to improve an unsatisfactory long-run outlook.

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Q. What have budget trends been over the short and long term?

A. Federal budget deficits are largely driven by external events—war, recession—in the near term and by demography in the long run. When events conspire to drive revenues above the trend, tax cuts usually bring them down with alacrity.

The budget deficit has been on a roller coaster in recent years because of the Great Recession and the subsequent recovery. (The federal budget deficit measures the amount by which total government outlays exceed total revenues in a given year.) In 2007, prior to the recession, the deficit had fallen to 1.1 percent of gross domestic product (GDP) despite the Afghan and Iraq wars and significant tax cuts earlier in the decade. Then the recession hit and the deficit soared to 9.8 percent of GDP by 2009, as tax revenues fell, automatic safety net programs kicked in, and hundreds of additional billions were spent to stimulate the economy. But the economic recovery and subsequent economic expansion quickly lowered the deficit again; by 2015 it was 2.5 percent of GDP. The downward trend came to a halt in 2016 when the deficit jumped to 3.2 percent of GDP. Under current law it is expected to continue to rise erratically to 4.6 percent by 2026.

SHORT TERM

The recovery has not been as kind to the debt-GDP ratio. (The federal debt is the total value of outstanding Treasury securities and measures how much the government owes.) Very large deficits during the recession caused it to double from 35.2 percent of GDP in 2007 to 74.1 percent at the end of 2014. The ratio fell to 73.6 percent in 2015, but rose to 76.6 percent in 2016. Under current law it is expected to continue rising until it reaches 85.5 percent in 2026. The increase is propelled by rapidly rising outlays for health and retirement programs.

The rapid rise in the debt-GDP ratio has had remarkably little impact on the interest bill facing the government. In fact, interest payments relative to GDP actually fell while the debt-GDP doubled because interest rates plunged extraordinarily.

The recession-induced increase in safety net spending and the fiscal stimulus package caused total spending to soar from 19.1 percent of GDP in 2007 to 24.4 percent in 2009, while revenues fell from 17.9 to 14.6 percent. Spending then fell in relative terms as the stimulus wound down and safety net and interest spending fell. By 2014, it was back down to 20.3 percent of GDP. The spending- GDP ratio rose slightly in 2015 and 2016 and by 2026 is expected to be up to 23.1 percent.

The slowdown in total spending growth was aided by an unusual slowdown in health cost growth. The total

Background

What have budget trends been over the short and long term?

cost of Medicare and Medicaid relative to GDP was no greater in 2014 than in 2009 despite aging of the baby boomers and effects of the Affordable Care Act on Medicaid.

LONG TERM

Over the longer run, however, CBO expects health costs to grow faster than the economy, but not quite as fast as in earlier decades.. They are being pushed upward by an aging population and by increasing health costs per enrollee in government programs.

The two largest health programs, Medicare and Medicaid, were created in 1965. Five years later their spending amounted to less than 1 percent of GDP. But by 2016 their spending had grown to 5.2 percent of GDP. A cumbersome price control system is in place to limit Medicare cost growth, but it has been far from successful, as the health sector tends to respond to limits on prices by prescribing more treatments.
Social Security spending has also been affected by aging of the population. Relative to GDP it rose from 2.8 percent in 1970 to 4.9 percent in 2016. Yet total government spending rose only from 18.7 to 21.0 percent over the same period. The total did not rise in proportion to health outlays and Social Security because defense and nondefense discretionary spending shrank in relative terms.

Defense spending was still being affected by the Vietnam War back in 1970, when it represented 7.8 percent of the GDP. In 2016 defense spending only amounted to 3.1 percent. Nondefense discretionary spending fell from 3.7 to 3.3 percent over the same period. It had been as high as 5.0 percent in 1978. It is clear that rising health and Social Security spending combined with a strong aversion to raising taxes is putting a severe squeeze on the rest of the government.

There seems to be a law of nature (or at least Washington political nature) that significant tax cuts follow whenever total revenues exceed 19 percent of GDP. The total tax burden reached this benchmark during World War II, the Korean War, and the Vietnam War, but in each case was quickly lowered after the war's end—or with Vietnam, after defense spending began to fall.

The inflation of the late 1970s again raised the total burden above 19 percent in 1981 as people were pushed into higher tax brackets. President Ronald Reagan enacted large tax cuts that year. The longest period with a tax burden above 19 percent was from 1998 through 2000. The 2003 and 2004 Bush tax cuts then lowered the burden in several steps to less than 16 percent.

Over the past 40 years the composition of receipts has not changed radically. The relative importance of income and payroll taxes has fluctuated over the decades, but both are only slightly more important now than they were in the mid-1970s. The importance of corporate, excise, and estate and gift taxes has declined over the same period.

Data Sources

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Q. How much spending is uncontrollable?

A. Entitlement spending is generally said to be uncontrollable for political rather than legal reasons. It can always be controlled legally by reforming programs, but when an entitlement is extremely popular, reform may require more political courage than is readily available.

The federal budget divides government spending into three categories, discretionary spending, mandatory or direct spending, and net interest. Discretionary spending, set in annual appropriations acts developed by the House and Senate Appropriations Committees, includes most defense programs as well as spending for education, transportation, environmental protection, law enforcement and border security, international assistance, and a host of other programs. Mandatory spending, controlled by laws other than appropriations act, includes spending on entitlement programs including the big three—Social Security, Medicare, and Medicaid—and many smaller programs such as supplemental nutrition assistance, federal civilian and military retirement benefits, and unemployment insurance.

Government spending on mandatory programs (most of which consists of spending on entitlement programs), and net interest on the public debt are often described as "uncontrollable." Entitlements can be controlled legally by reforming them, but this can be highly unpopular politically. Interest costs can be controlled indirectly by curbing spending growth or raising revenues, but that is also never easy.

Uncontrollable spending has been growing much more rapidly than total spending and thus accounts for an ever-larger share of the total. However, most growth has been concentrated in entitlements that serve the elderly and in health insurance. The population has been aging rapidly, and that affects both Social Security and health programs. The latter have grown doubly rapidly because health costs per beneficiary have been growing faster than incomes per capita. Health cost growth has slowed recently, but the Congressional Budget Office expects it to reaccelerate in the long run. Social Security and Medicare, the largest health program, are among the most politically popular programs ever invented.

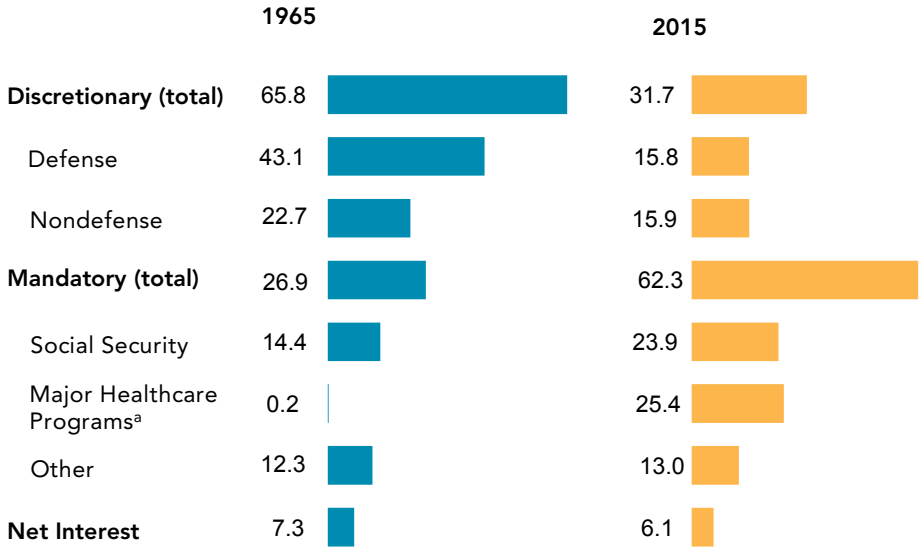
Whereas discretionary programs are funded by specific appropriations that generally last only one year, entitlement spending for Social Security and Medicare is ongoing and is not scrutinized as carefully or as often as discretionary spending. The laws establishing entitlements specify who is eligible for benefits and describe the nature of the benefits. The government then pays for as many eligible individuals as claim them. Thus,

total entitlement spending cannot be predicted with precision from year to year and is, in this narrow sense, "uncontrollable."

As a matter of law, though, entitlement spending can be controlled in the long run by changing eligibility criteria or the generosity of benefits. This would require Congress to actively change the law, but as implied above, that is politically perilous. In contrast, unless renewed, a discretionary program will automatically expire when its funding does. Discretionary spending is therefore often assumed to be easier to control 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.

FIGURE 1

Spending as a Percentage of Total Spending in 1965 and 2015



Source: Congressional Budget Office, Historical Budget Data, March 2016; author calculations.
Note: (a) Spending on Medicare (net of offsetting receipts), Medicaid, the Children's Health Insurance Program, and subsidies offered through health insurance exchanges and related spending.

Background

How much spending is uncontrollable?

Other forms of mandatory spending include contractual obligations, for example, liabilities related to the procurement of goods and services. It's worth remembering, too, that the government may have to pay damages when it loses lawsuits. Such spending is more difficult to control legally, but it is a small portion of the total.

In fiscal 1965, mandatory spending plus net interest constituted 34.2 percent of total spending. By fiscal 2015 the share had doubled to 68.4 percent. Over the same period, Social Security's share of total spending rose from 14.4 percent to 23.9 percent. Medicare and Medicaid were created in 1965 and were responsible for a small portion of total spending throughout the rest of the 1960s. But by 2015 they and other health care programs consumed 25.4 percent of outlays. In contrast, defense discretionary spending fell over the same period from 43.1 percent of total spending at the peak of the Vietnam War to 15.8 percent in 2015. The percentage of total spending devoted to nondefense discretionary programs also fell from 22.7 percent in 1965 to 15.9 percent in 2015, but this has fluctuated significantly over the period.

Data Sources

Congressional Budget Office. 2016. Updated Budget Projections: 2016 to 2026. Historical Budget Data, March 2016.

Q. What are tax extenders?

A. Several dozen temporary tax breaks are scheduled to expire at the end of 2016. They are collectively known as the "tax extenders" because lawmakers likely will consider extending most or all of them. The temporary-but-not-temporary character of these provisions complicates tax policy and budgeting.

THE TAX EXTENDERS

Congress often enacts temporary tax provisions, almost all of which are tax cuts. Some of these are made temporary to force review when they're scheduled to ex-pire or "sunset." Some are temporary because Congress intended them to address temporary needs, such as recession, mortgage market collapse, or regional weath-er disasters. And some are temporary because proponents want them to be per-manent but cannot muster the budgetary resources to offset the cost for more than a year or two at a time.

These temporary tax provisions are often known as the "expiring provisions," since they are scheduled to expire or, in some years, already have. Of particular importance are several dozen temporary tax cuts that will expire this year. Most reward business and consumer investments in energy efficiency and production, and use of alternative fuels. Other business provisions provide tax reductions for auto racetracks and race horses. The largest individual extender excludes mortgage forgiveness from income. These provisions are collectively known as the "tax extenders" because of the expectation that lawmakers will consider extending most or all of them either this year or in 2017.

THE 2015 DEAL ON TAX EXTENDERS

At the end of 2015, lawmakers made permanent many provisions that had previ-ously been temporary. Those included the research and experimentation credit (which had been temporarily renewed 16 times since 1981), the "subpart F excep-tions" that allow financial firms to defer tax on some international income (renewed seven times since 1998), the personal deduction for state and local sales taxes (renewed four times since 2004), and more than a dozen other expired pro-visions. The law also made permanent expansions of the Earned Income Tax Credit, the Child Tax Credit, and the American Opportunity Tax Credit that were sched-uled to expire at the end of 2017. Originally enacted as part of the economic stimulus in 2009 and extended in the fiscal cliff deal at the close of 2012, these provisions help working families with kids, encourage work, reduce marriage pen-alties, and help with education expenses.

Background

What are tax extenders?

The law thus made permanent many of the largest and most politically important expiring provisions. Dozens of temporary provisions remain, but tax extender de-liberations now have lower stakes than in recent years.

OTHER EXPIRING PROVISIONS

Several other tax breaks are scheduled to expire between 2017 and 2025. Most important are a group of provisions expiring at the end of 2019, including the Work Opportunity Tax Credit and the New Markets Tax Credit.

POLICY IMPLICATIONS

There are often good reasons for making some tax provisions temporary. If Con-gress enacts tax cuts to soften the blow from disasters and recessions, it makes sense to limit their duration. Sunsetting tax breaks after several years can also in-spire more congressional oversight than permanent features of the tax code may receive.

In practice, though, Congress often extends tax breaks a year or two at a time merely to meet the letter of the law governing congressional budget procedures. Budget rules often (but not always) require lawmakers to find offsetting revenue increases or spending cuts to pay for extending a tax break. Finding such offsets is easier for a temporary extension than for a permanent one.

It should be no surprise, then, that the number of expiring provisions snowballed, with over 50 identified as extenders before the recent law and more than 30 still remaining. The large number makes it less likely that Congress will consider their merits as individual provisions.

BUDGET IMPLICATIONS

The Congressional Budget Office (CBO) must assume that these temporary-but-not-temporary laws will expire 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 are almost always extended. Moreover, because most extenders involve tax cuts, the assumption that these provisions will expire leads CBO to 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.

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Q. What are options for raising revenues?

A. Policymakers can directly increase revenues by increasing tax rates, reducing tax breaks, expanding the tax base, improving enforcement, and levying new taxes. They can indirectly increase revenues through policies that increase economic activity, income, and wealth.

OPTIONS FOR OUR EXISTING SYSTEM

1. Congress could increase the tax rates that apply to personal income, corporate in-come, payrolls, estates, and specific products like gasoline and cigarettes. Higher rates almost always yield higher revenues, even if people and businesses do less of the taxed activity. Capital gains, which are currently taxed at a top rate of 23.8 percent, are one exception; some estimates suggest revenues may peak at rates around 30 percent and then decline.
2. Congress could scale back or eliminate the myriad tax breaks in the existing code. Prominent personal examples include the exclusion of employer-provided health insurance, the mortgage interest deduction, retirement saving incentives, and the charitable deduction. Prominent business examples include accelerated deprecia-tion, deferral of taxes on overseas income, and the domestic manufacturing de-duction.
3. Congress could apply existing taxes more broadly. For example, it could reduce the personal exemption in the individual income tax, increase the cap on earnings subject to the Social Security payroll tax, or reduce the amount of the estate tax exemption.
4. The federal government could strengthen enforcement. The IRS estimates that the "tax gap"—the difference between taxes owed and those actually paid—averaged about $458 billion annually in 2008-2010 and that enforcement efforts and penalties recovered about $52 billion. Better enforcement could further reduce the remaining $406 billion gap.

NEW OPTIONS

Policymakers could also boost revenues by introducing new taxes. The largest po-tential revenue sources would be a value-added tax (already levied in every other developed nation) or a carbon tax (which would target the pollutants causing cli-mate change). Other recent proposals include taxes on financial transactions, wealth, and unhealthy foods and drinks.

Background

What options would increase federal revenues?

BOOSTING ECONOMIC ACTIVITY

All else equal, a bigger economy generates more tax revenue. Policies that boost economic activity, incomes, and wealth can thus lift revenues as well. Examples in-clude policies that increase the number of people in the labor force, the number of hours they work, their skills, and physical and intellectual capital.

Immigration reform is one way to boost economic activity. Bringing new workers into the country would expand the labor force and attract new capital; allowing unauthorized workers to enter the legal workforce would boost their productivity and taxable wages.

Other policies that might boost economic activity include investing in infrastruc-ture, education, and innovation; reforming the rules of social programs that dis-courage some people from working; and restructuring the tax code to encourage domestic investment. Actual economic gains depend on policy specifics; poorly-designed investments and reforms could boomerang, reducing economic activity.

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Q. What does it mean for a government program to be off-budget?

A. The two Social Security trust funds and the Postal Service are "off-budget"—their spending and receipts are walled off from the rest of the budget. Putting Social Security and the Post Office "off-budget" shields them from some budget pres-sures, but policymakers often fo-cus on the unified budget that includes them. A few other agencies are excluded because of their independence (e.g., the Federal Reserve) or private character (e.g., government-sponsored, privately owned en-ti-ties and funds managed for private citizens).

OFF-BUDGET VERSUS ON-BUDGET ACOUNTING

The budget brings together the spending and receipts of virtually all federal activi-ties, from paying doctors who treat Medicare patients to financing the Environ-mental Protection Agency to collecting income taxes to selling oil leases on federal land. In two cases, however, Congress has separated programs from the rest of the budget. The Postal Service Fund and the disability and retirement trust funds in Social Security are formally designated as "off-budget," even though their spending and revenues are included in the unified budget.

Lawmakers created this special accounting to try to wall off these programs. For the Postal Service, the intent was to free the agency to pursue more efficient prac-tices than the conventional budget process allows. But that has not helped it avoid financial difficulties.

With Social Security, the intent was to protect any surpluses from being diverted into other programs. The two Social Security trust funds have accumulated large surpluses since 1983. Those surpluses will eventually be drawn down to pay future benefits. It was therefore argued that those surpluses should be separated from the surplus or deficit of the rest of government. Congress hoped that this separa-tion would induce greater fiscal discipline in the rest of the government.

RESULTS

This accounting has had mixed results. Congressional budget rules prevent spend-ing reductions or revenue increases in Social Security from being explicitly used to pay for spending increases or tax cuts elsewhere in the budget. In that sense, off-budget accounting has protected the program. But high-level budget

discussions focus on the unified budget deficit and thus ignore the off-budget versus on-budget distinction. As a result, Social Security surpluses have effectively helped finance deficits elsewhere in the government. Just how much is unclear, but in the more than two decades that Social Security has been off-budget, the rest of gov-ernment has run a surplus in only two years (1999 and 2000).

In any case, these arguments have less relevance today. Annual Social Security ex-penditures have exceeded noninterest income since 2010. The combined trust funds still run a surplus because of interest payments from the Treasury, but these payments are simply transfers from one government office to another and therefore do not affect the unified deficit.

THE FEDERAL RESERVE SYSTEM

The Federal Reserve System (the Fed) is part of the federal government but is ex-plicitly excluded from the budget in order to shield monetary policymakers from political pressure. Other developed nations do the same. The Fed thus sets its own spending and finances itself from earnings on lending to banks and owning finan-cial assets. The Fed remits its profits to Treasury each year, which the budget rec-ords as receipts, but the agency otherwise operates outside the budget.

OTHER ACTIVITIES OUTSIDE THE BUDGET

Some federal activities are outside the budget because the government plays a limited role in what is otherwise a private activity. The government manages vari-ous funds whose assets belong to Indian tribes, federal employees, copyright holders, and other private individuals. Spending from and receipts to those funds are generally not included in the budget.

Government-sponsored enterprises, such as the Federal Home Loan Banks, also fall outside the budget because they are privately owned and their debt does not bear the full faith and credit of the US government. However, most observers assume their close ties to the government would lead to a government bailout if they got into financial trouble.

That assumption proved accurate for Fannie Mae and Freddie Mac, the giant mortgage finance enterprises. When they became insolvent during the financial crisis, they received substantial financial assistance and were put into federal con-servatorship. This has led to a dispute regarding their status. The Office of Man-agement and Budget believes they are still sufficiently private to fall outside the budget. The Congressional Budget Office believes federal control is now so strong that the two entities are effectively federal agencies and their spending and re-ceipts should be in the budget.

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Q. How do taxes affect the economy in the short run?

A. Primarily through their impact on demand. Tax cuts boost demand by increasing disposable income and by encouraging businesses to hire and invest more. Tax increases do the reverse. These demand effects can be substantial when the economy is weak, but are smaller when it is operating near capacity.

TAXES AND SHORT-RUN DEMAND

Economic activity reflects a balance between what people, businesses, and gov-ernments want to buy and what they want to sell. In the short run—focusing on the next one or two years—economic policy has greater impact on the demand side. When the economy is weak, for example, the Federal Reserve tries to boost consumer and business demand by cutting interest rates or purchasing financial securities. Congress, for its part, can boost demand by increasing spending and cutting taxes.

Tax cuts increase household demand by increasing workers' take-home pay. Tax cuts can boost business demand by increasing their after-tax cash flow, which can be used to pay dividends and expand activity, and by making hiring and investing more attractive.

MULTIPLIERS

How much tax cuts boost demand (or tax hikes restrain it) depends on the sensitiv-ity of household and business behavior—for example, how households divide in-creased after-tax income between consumption and saving, and whether business-es choose to hire and invest more. Economists summarize these effects in a simple measure, the output multiplier, expressing how many dollars of increased econom-ic activity result from a dollar reduction in taxes or a dollar increase in government spending. The Congressional Budget Office (CBO) recently estimated such multi-pliers for a mix of tax and spending policies (table 1).

As these estimates suggest, the potential stimulus from tax cuts or spending in-creases depends on the strength of the economy. If it is operating close to poten-tial and the Federal Reserve is not constrained by the zero lower bound on interest rates, fiscal policies will have a relatively small short-run economic effect. How-ever, if the economy is far from potential and short-term interest rates are close to zero, fiscal stimulus can have significantly more impact. CBO estimates that fiscal multipliers are about three times larger when the economy is very weak than when it is strong.

Background

How do taxes affect the economy in the short run?

TABLE 1

Output Multipliers for Federal Fiscal Policies

	Economy Well Below Potential		Economy Close to Potential	
	Low	High	Low	High
Tax cuts				
Lower- and middle-income people, two years	0.3	1.5	0.1	0.5
Higher-income people, one year	0.1	0.6	0.0	0.2
First-time homebuyer credit, extension	0.2	0.8	0.1	0.3
Corporate tax provisions primarily affecting cash flo	0.0	0.4	0.0	0.1
Transfer payments				
Individuals	0.4	2.1	0.1	0.7
Retirees	0.2	1.0	0.1	0.3
Transfers to state and local governments				
Infrastructure	0.4	2.2	0.1	0.7
Other purposes	0.4	1.8	0.1	0.6
Purchases of goods and services	0.5	2.5	0.2	0.8

Source: Charles J. Whalen and Felix Reichling, "The Fiscal Multiplier and Economic Policy Analysis in the United States," Congressional Budget Office Working Paper, February 2015.
Notes: If the economy is well below potential, output gains are spread over one (Low) to four quarters (High). If the economy is operating close to potential, output gains are spread over one (Low) to three (High) quarters and are partly offset by output losses through the eighth quarter.

CBO's numbers illustrate substantial uncertainty in our understanding of how fiscal policies affect the economy. For a two-year tax cut aimed at lower- and middle-income households, for example, CBO's low estimate of the multiplier (0.3) is just one-fifth the size of its high estimate (1.5).

But some things are clear. CBO's estimates suggest that, dollar for dollar, tax cuts are often a less effective means of stimulus than are spending increases. If the federal government purchases goods and services itself (or helps state and local governments do so), most or all of the spending will boost demand. If the gov-ern-ment cuts personal taxes, however, a substantial amount of the added spend-ing power leaks into saving. That dampening effect can be moderated by target-ing tax cuts to lower- and middle-income households, which are less likely to save.

Background

How do taxes affect the economy in the short run?

OTHER SHORT-RUN EFFECTS

Tax policies can also affect the supply of labor in the short run. A cut in payroll taxes could bring some workers into the labor market or encourage those already working to put in more hours. Such supply changes have little effect on output if the economy is operating well below potential. If the economy is operating near potential, however, increased labor supply can translate to increased output.

THE TAX POLICY CENTER'S MODEL

The Tax Policy Center has a model of short-run economic effects that is designed to produce estimates similar to those of the CBO. It differs from CBO's approach in that direct effects on demand are estimated based on effects on after-tax in-comes derived from TPC's distributional tables rather than on generic policy types as in Table 1. TPC first used this model to estimate the short-run economic and revenue effects of the tax plans of Hillary Clinton and Donald Trump (Page 2016, Page and Smetters 2016).

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Q. How do taxes affect the economy in the long run?

A. Primarily through the supply side. High marginal tax rates can discourage work, saving, investment, and innovation, while specific tax preferences can affect the allocation of economic resources. But tax cuts can also slow long-run economic growth by increasing deficits. The long-run effects of tax poli-cies thus depend not only on their incentive effects but also their deficit effects.

Economic activity reflects a balance between what people, businesses, and governments want to buy and what they want to sell. In the short run, demand factors loom large. In the long run, though, supply plays the primary role in determining economic potential. Our productive capacity depends on the size and skills of the workforce; the amount and quality of machines, buildings, vehicles, computers, and other physical capital that workers use; and the stock of knowledge and ideas.

TAX INCENTIVES

By influencing incentives, taxes can affect each of these factors. Reducing marginal tax rates on wages and salaries, for example, can induce people to work more. Expanding the earned income tax credit can bring more low-skilled workers into the labor force. Lower marginal tax rates on the returns to assets (such as interest, dividends, and capital gains) can encourage saving. Reducing marginal tax rates on business income can cause some companies to invest domestically rather than abroad. Tax breaks for research can encourage the creation of new ideas that spill over to help the broader economy. And so on.

Note, however, that tax reductions can also have negative supply effects. If a cut increases workers' after-tax income, some may choose to work less and take more leisure. This "income effect" pushes against the "substitution effect," in which lower tax rates at the margin increase the financial reward of working.

Tax provisions can also distort how investment capital is deployed. Our current tax system, for example, favors housing over other types of investment. That differen-tial likely induces overinvestment in housing and reduces economic output and so-cial welfare.

BUDGET EFFECTS

Tax cuts can also slow long-run economic growth by increasing budget deficits. When the economy is operating near potential, government borrowing is financed by diverting some capital that would have gone into private investment or by bor-rowing from foreign investors. Government borrowing thus either crowds out

Background

How do taxes affect the economy in the long run?

pri-vate investment, reducing future productive capacity relative to what it could have been, or reduces how-much of the future income from that investment goes to US residents. Either way, deficits can reduce future well-being.

The long-run effects of tax policies thus depend not only on their incentive effects but on their budgetary effects. If Congress reduces marginal tax rates on individual incomes, for example, the long-run effects could be either positive or negative depending on whether the resulting impacts on saving and investment out-weigh the potential drag from increased deficits.

PUTTING IT TOGETHER

That leaves open questions on how large these effects are, and how to model them for the purpose of analyzing policy changes. The Congressional Budget Of-fice and the Joint Committee on Taxation each use multiple models that differ in assumptions about how forward-looking people are, how the United States con-nects to the global economy, how government borrowing affects private invest-ment, and how business-es and individuals respond to tax changes. Models used in other government agencies, in think tanks, and in academia vary even more. The one area of consensus is that the most pro-growth policies are those that improve incentives to work, save, invest, and innovate without driving up long-run deficits.

The Tax Policy Center has partnered with the Wharton School of the University of Pennsylvania to analyze the long-run economic effects of tax proposals. The Penn-Wharton Budget Model is an overlapping-generations model in which simulated households make work and saving decisions to maximize their well-being subject to given government policies and economic conditions. TPC first used this model to estimate the economic and revenue effects of the tax proposals of Hillary Clinton and Donald Trump (Page 2016, Page and Smetters 2016).

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Q. What are dynamic scoring and dynamic analysis?

A. Tax, spending, and regulatory policies can affect incomes, employment, and other broad measures of economic activity. Dynamic analysis accounts for those macroeconomic impacts, while dynamic scoring uses dynamic analysis in estimat-ing the budgetary impact of proposed policy changes.

BUDGET SCORING

The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) estimate the budgetary effects of tax, spending, and regulatory legislation. The resulting scores play a major role in policy deliberations because of congres-sional budget rules and public concern about the budget.

CBO and JCT recognize that households' and businesses' economic activity can be sensitive to changes in policy. An increase in the cigarette tax, for example, will reduce smoking, while new subsidies for health insurance will increase coverage. The agencies account for those behavioral responses in their estimates.

For many years, however, CBO and JCT budget scores did not account for the secondary impact on employment, gross domestic product, and other macroeco-nomic measures. The agencies often analyzed those macroeconomic impacts sepa-rately in what is called dynamic analysis, but did not include their feedback effects in official scores. An exception is immigration reform scoring: the effects on popu-lation and labor force are so direct that CBO and JCT did account for them.

In 2015, Congress adopted new budget rules that required dynamic scoring in cer-tain cases. CBO and JCT now include macroeconomic feedback in official scores if proposed legislation has a sufficiently large budget impact (more than 0.25 per-cent of gross domestic product in any year in the budget window, equivalent to about $45 billion in 2016) or if one of the budget committee chairmen requests it. These rules cover major tax and mandatory spending proposals; an unresolved question is how these rules might also apply to investments, like infrastructure and education, funded through discretionary spending.

For dynamic scoring, CBO and JCT prepare conventional, nondynamic scores of proposed legislation and then use economic models to identify any short- or long-run effects on the overall economy. The agencies then estimate the budget effects of those macroeconomic feedbacks. The agencies have long done dynamic anal-yses of major legislation, using multiple models and parameter estimates. A major difference with dynamic scoring is the distillation of those scenarios down to the single set of estimates the budget process requires.

Background

What are dynamic scoring and dynamic analysis?

CASE STUDY: REPEALING THE AFFORDABLE CARE ACT

In the first major analysis under the new rules, CBO and JCT analyzed the potential budget effects of repealing the Affordable Care Act (ACA). Including macroeco-nomic feedback, they estimated that repeal would increase cumulative deficits by $137 billion over the next decade. With conventional scoring, the estimated deficit increase would have been larger, $353 billion (figure 1).

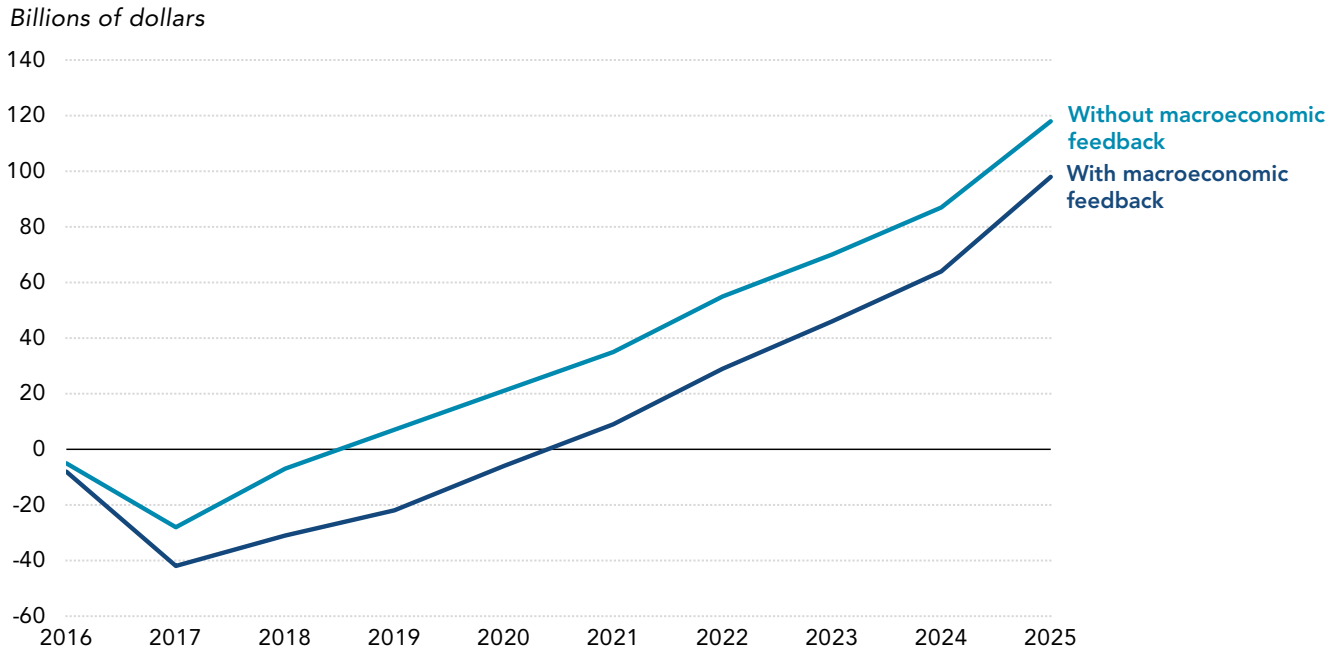
That difference arises because the agencies' best estimates—subject, they empha-size, to significant uncertainty—suggest that the ACA slightly reduces overall eco-nomic activity. For one thing, by expanding Medicaid coverage the ACA allows some people to get health insurance while working fewer hours. For another, by phasing out premium subsidies as individual incomes rise and by levying new taxes, the ACA effectively raises taxes at the margin and thus reduces work incentives.

Reduced labor supply, coupled with other taxes, also reduces the capital stock within the 10-year budget window (beyond the window, the ACA's deficit reduc-tions tend to expand the capital stock). Through its macroeconomic feedbacks, the ACA thus slightly reduces income and payroll tax revenues.

FIGURE 1

Estimated Effects on Deficits of Repealing the Affordable Care Act

By fiscal year



Sources: Congressional Budget Office (2015); staff of the Joint Committee on Taxation.
Note: The term "macroeconomic feedback" refers to the estimated effects on the federal budget that would arise from changes in economic output or other macroeconomic variables—such as changes in the number of hours that people work and in their aggregate compensation, which would change revenues, or changes in interest rates, which would change interest payments.

Background

What are dynamic scoring and dynamic analysis?

DYNAMIC ANAYLSIS BY THE TAX POLICY CENTER

In 2016, the Tax Policy Center published its first dynamic analyses, partnering with the Wharton School of the University of Pennsylvania to analyze the tax plans of presidential candidates Hillary Clinton and Donald Trump. Those analyses found only modest dynamic effects on estimated revenue, largely because any incentive effects were eventually outweighed by the impact on budget deficits. In the case of the Clinton plan, the macroeconomic effects of reduced incentives to work and save were eventually outweighed by the increase in saving and investment from lower budget deficits. In the case of the Trump plan, increased incentives to work and save were eventually outweighed by the reduced saving and investment from much higher budget deficits.

CONTROVERSY OVER DYNAMIC SCORING

In principle, dynamic scoring should not be controversial. Policymakers and the public want to know how policy changes may affect the budget, whether through direct behavioral responses or macroeconomic feedback. In practice, however, dy-namic scoring has been controversial: Advocates for a tax cut or some entitlement reforms often appear to hope that dynamic scoring will make enacting them easi-er. Opponents fear the advocates will be right.

In reality, the effect will be more muted. Dynamic scores for tax cuts will include the pro-growth incentive effects that advocates emphasize. But dynamic scores will also account for offsetting effects, such as higher deficits crowding out in-vestment or people working less because their incomes rise. The net of incentive and offsetting effects often yields smaller growth projections than advocates hope. Indeed, dynamic scoring sometimes shows that tax cuts are more expensive than conventionally estimated, usually when pro-growth incentives are not big enough to offset anti-growth effects.

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Q. Do tax cuts pay for themselves?

A. At current tax rates, the direct revenue loss from tax cuts almost always ex-ceeds the indirect gain from increased activity or reduced tax avoidance. Tax cuts can, however, partly pay for themselves. How much depends on how people respond to tax changes.

TAXES AND REVENUES

Economic activity generally responds to tax changes. If you increase the tax on cigarettes, people will smoke less and some will shift to illegal, untaxed cigarettes. Income taxes also trigger a response. If you increase the tax rate on wages and salaries, some people will work less. (Some will also work more to recoup lost af-ter-tax income, but evidence suggests that the disincentive effect dominates.)

Meanwhile, some people will work off the books. Some will hire lawyers to convert their salary income into less-taxed capital income. And some will devote more effort to using tax-advantaged retirement savings, charitable deductions, and other tax breaks to cut their taxable incomes. All these responses reduce the po-tential revenue gain from increasing tax rates.

The same is true in reverse. If the government reduces tax rates on an activity people will do more of it and will devote less effort to legal avoidance and illegal evasion. In principle, those responses could be so large that a tax increase would reduce revenue or a tax cut would increase revenue. In practice, however, these paradoxical effects are extremely rare. Tax cuts thus almost never pay for them-selves in full.

But cuts can and do pay for themselves in part. If a 10 percent reduction in a tax rate yields a 3 percent increase in taxable income, for example, revenues fall by only 7 percent. Taxpayer responses would thus pay for 30 percent of the tax cut. Real-world examples can be more complex; a change in income tax rates, for ex-ample, could affect both payroll and income tax receipts.

THE LAFFER CURVE

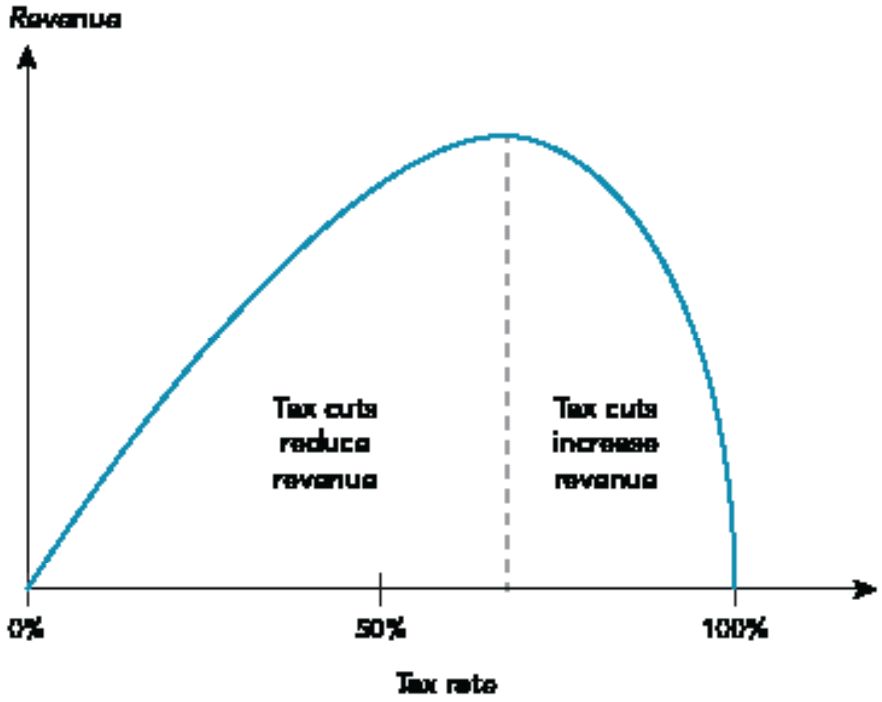
Economist Arthur Laffer helped popularize the idea that the revenue effects of tax changes depend on taxpayers' response. Figure 1 shows a hypothetical Laffer curve that tracks how revenues depend on the tax rate.

Background

Do tax cuts pay for themselves?

FIGURE 1

A Hypothetical Laffer Curve



We should expect that revenues would be very low when tax rates are close to ei-ther zero or 100 percent. At some point in between—65 percent in this hypothet-ical—revenues peak.

That much is uncontroversial. Debates often arise, however, about the shape of the Laffer curve and where on the curve current tax rates fall.

RESPONSIVENESS

A government's ability to raise revenues by raising tax rates is limited by how people respond. A local government's ability to raise revenues by taxing hotel stays, for example, is limited by how easily potential hotel patrons can find ac-commodation in lower-tax communities. A state's ability to tax personal incomes, by the same token, is limited by taxpayers' willingness to move to lower-tax states to avoid the added levy. Likewise, the federal government's ability to tax corpora-tions is limited by corporations' ability to move economic activity—in substance or merely in form—to lower-tax nations. And so on.

Background

Do tax cuts pay for themselves?

Responses depend on economic and policy conditions. A tax cut is a bigger deal, for example, when marginal tax rates are 70 percent than when they are 40 per-cent. Responsiveness also varies with the difficulty of changing behavior. Taxpay-ers can avoid capital gains taxes, for example, by holding appreciated stock and other assets until death or by donating them to charity. As a result, some analysts estimate that the Laffer curve for capital gains taxes peaks around a 30 percent federal rate. If the government scaled back those tax-reduction opportunities, however, taxpayers would have less ability to defer or avoid capital gains taxes and the peak rate would be higher.

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Background

On what do economists agree and disagree about the effects on taxes on economic growth?

Q. On what do economists agree and disagree about the effects of taxes on economic growth?

A. Economists generally agree that people and businesses respond to taxes and that large tax changes can move the economy. But econo-mists have not (and probably cannot) pin down exactly how the econ-omy works and how responsive people and businesses are to policy changes. As a result, econo-mists often disagree about what models and parameters to use to analyze tax policies. Those scientific disagree-ments are sometimes amplified by value judgments about appropriate policy.

AREAS OF AGREEMENT

Economists often agree about the general effects of tax policy. For example, they agree that people respond to incentives, taxes can change incentives, and there-fore taxes can change behavior. A tax on cigarettes reduces smoking and shifts some purchases to untaxed markets. The Earned Income Tax Credit brings more low-wage single parents into the workforce. Investors are less likely to realize capi-tal gains when tax rates are high. Businesses shift their legal structures, and some-times the location of their activity, to lower tax bur-dens. When faced with a scheduled tax increase or decrease, people and businesses move income into the lower-taxed periods. And so on.

Economists also generally agree that large tax changes can move the economy. When the economy is oper-ating far below potential, for example, tax cuts can help stimulate activity, while tax increases can hamper it. In the longer run, a tax system with low rates and a broad base is more likely to promote prosperity than one with high rates and a narrow base.

Within those broad areas of agreement, economists often disagree about the size and importance of poten-tial effects.

Background

On what do economists agree and disagree about the effects on taxes on economic growth?

THE LIMITS OF ECONOMIC SCIENCE

In practice, economics blends scientific rigor with value judgments. The science tries to understand how the economy works. The philosophy draws inferences about what better and worse policies may be.

The science part is incomplete. There is no consensus, for example, on what as-sumptions to use to analyze the macroeconomic effects of tax policy. The Con-gressional Budget Office (CBO) and the Joint Committee on Taxation, for example, each use multiple models with different assumptions of how forward-looking people are (ranging from complete myopia to perfect foresight), how the United States connects to the global economy, and other dimensions.

Within any modeling framework, moreover, there is significant uncertainty about the size of potential effects. In modeling the short-run consequences of fiscal poli-cy, for example, CBO estimates that the fiscal "multiplier" for a two-year tax cut to lower- and middle-income households is 0.3 to 1.5—a fivefold difference. Such wide ranges exist because the evidence is inadequate to pin down key parameters. And the resulting uncertainty is amplified because there are good reasons to believe that the economy has changed sufficiently to make the past an imperfect predictor of the future.

VALUE JUDGMENTS

For those reasons, there is substantial scope for scientific disagreement about the economic effects of tax policy. But that is not the only reason economists disagree. Value judgments can also color views about tax policy.

In an IGM Forum survey of leading economists, 90 percent either agreed or strongly agreed that one "reason why economists often give disparate advice on tax policy is because they hold differing views about choices between raising aver-age prosperity and redistributing income."

In principle, economists should be able to distinguish such value differences from objective analysis. In practice, however, the two blur. Opponents of redistribution-al policies often argue, for example, that the policies will have large negative side effects, while advocates often argue that those effects are small. Some of that dif-ference is sincere. If you believe the negative side effects of a policy are large, it makes more sense to oppose it, and vice versa. However, the causality can also run the other way, with analysts emphasizing the estimates most consistent with their values.

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Q. What is the role of monetary policy in business cycles?

A. Economists view monetary policy as the first line of defense against economic slowdowns because the Federal Reserve can act faster than the President or Congress, and it is better equipped to judge the appropriate timing and magnitude of economic stimulus.

The Federal Reserve can adjust monetary policy more quickly than the President 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 slowly to changes in economic conditions: 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 consumers' pockets. 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 present economic conditions, on projections of likely future conditions, and on assessments of possible risks to both economic activity and inflation. Forecasting economic conditions—or even determining the current state of the economy—is inherently difficult, given limitations in the data available 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.

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Background

What are automatic stabilizers and how do they work?

Q. What are economic stabilizers and how do they work?

A. Automatic stabilizers are features of the tax and transfer systems that temper the economy when it overheats and provide economic stimulus when the economy slumps, without direct intervention by policymakers.

Automatic stabilizers 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. Altogether, a 2013 study estimated that if transfer payments were reduced in size by 0.6 percent of GDP, U.S. output and hours worked would be about 4 and 8 percent more volatile, respectively.

The Congressional Budget Office estimates that through increased transfer payments and reduced taxes, automatic stabilizers provided significant economic stimulus during and in the aftermath of the Great Recession of 2007-2009, and thereby helped strengthen economic activity. That stimulus amounted to more than $300 billion annually in 2009 through 2012, an amount equal to or exceeding 2.0 percent of potential GDP in each year. (Potential GDP measures the maximum sustainable output of the economy.)

Background

What are automatic stabilizers and how do they work?

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.

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Q. What characteristics make fiscal stimulus most effective?

A. When the economy is operating below its potential, fiscal stimulus can raise output and incomes in the short run. To have the greatest impact with the least long-run cost, the stimulus should be timely, temporary, and targeted.

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. Timely, so that its effects are felt while economic activity is still below potential; when the economy has recovered, stimulus becomes counterproductive. Temporary, to avoid raising inflation and to minimize the adverse long-term effects of a larger budget deficit. And 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.

TIMELY

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

TEMPORARY

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 through monetary policy. This means that, most of the time, fiscal stimulus would not increase output, but instead simply crowd out other economic activity or induce the Federal Reserve to tighten monetary policy in order to keep inflation down.

Over the long run, permanent tax cuts or increases in government spending 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, and at a much lower long-run cost.

Background

What characteristics make fiscal stimulus most effective?

TARGETED

Fiscal stimulus should be well targeted in two ways. First, it should go to households or businesses most likely to raise spending in response to the stimulus and thus increase gross domestic product in the short run. Second, it should provide the greatest benefit to 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 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 helps protect them from the downturn while also boosting the economy.

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Q. How are federal taxes distributed?

A. Although enterprises (e.g., retailers, employers) are legally obligated to pay certain taxes, the burden of all taxes ultimately falls on households.

Individuals, businesses, and other entities may have the legal obligation to pay certain taxes, but the economic burden (or incidence) of all taxes ultimately falls on households. This burden may be felt through a reduction in household income or higher prices for goods and services.

The incidence of taxes has been studied for decades, and there is now fairly broad agreement on how it is distributed across households. The Tax Policy Center, in preparing standard distribution tables, assumes the following about federal taxes:

INDIVIDUAL INCOME TAX

Taxpayers (who either pay the tax directly or receive a refundable credit) bear the entire burden of the individual income tax.

PAYROLL TAXES

Employees (or self-employed people who pay both shares of the tax) bear both the employer and the employee share of the Social Security and Medicare payroll tax in the form of lower take-home income.

CORPORATE INCOME TAX

The corporate income tax reduces both wages and returns to capital. Income from capital (e.g., dividends, rents, interest, and capital gains) bears four-fifths of the burden, with wages and other sources of labor income bearing the remaining fifth.

ESTATE TAX

These costs are borne entirely by decedents.

Background

How are federal taxes distributed?

EXCISE TAXES

These also are assumed to reduce wages and returns to capital. They also increase the relative price of taxed goods and services, so households that consume relatively more of the taxed items bear a higher burden.

The Joint Committee on Taxation (JCT), US Department of Treasury's Office of Tax Analysis, and the Congressional Budget Office make similar incidence assumptions in their analyses, but with a few differences. For instance, JCT assumes that the tax on individual income that represents a return to capital from noncorporate businesses, like partnerships, is borne in the same manner as the corporate income tax. Moreover, each of these groups follows slightly different incidence assumptions for the corporate income tax, reflecting the great degree of uncertainty over the incidence of this tax.

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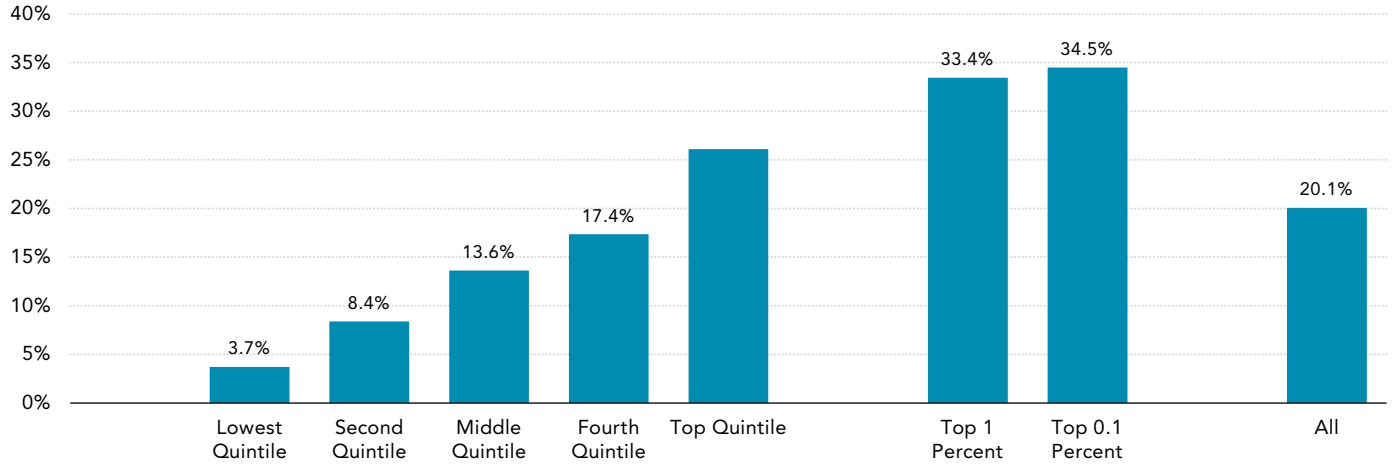
Q. Are federal taxes progressive?

A. Overall, yes. But that's not the case for each tax.

FIGURE 1

Average Effective Tax Rates by Expanded Cash Income Group

All federal taxes, 2017[a]



Sources: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1)
(a) Taxes included are individual income, payroll, corporate income, estate, and excise.

Although the overall federal tax system is progressive, with total federal tax burdens a larger percentage of income for higher-income households than for lower-income households, not all taxes within the federal system are equally progressive. Some federal taxes are actually regressive as they are a larger percentage of income for lower-income than for higher-income households.

The individual and corporate income taxes and the estate tax are all progressive. By contrast, payroll taxes for Social Security and Medicare and excise taxes are regressive (figure 2).

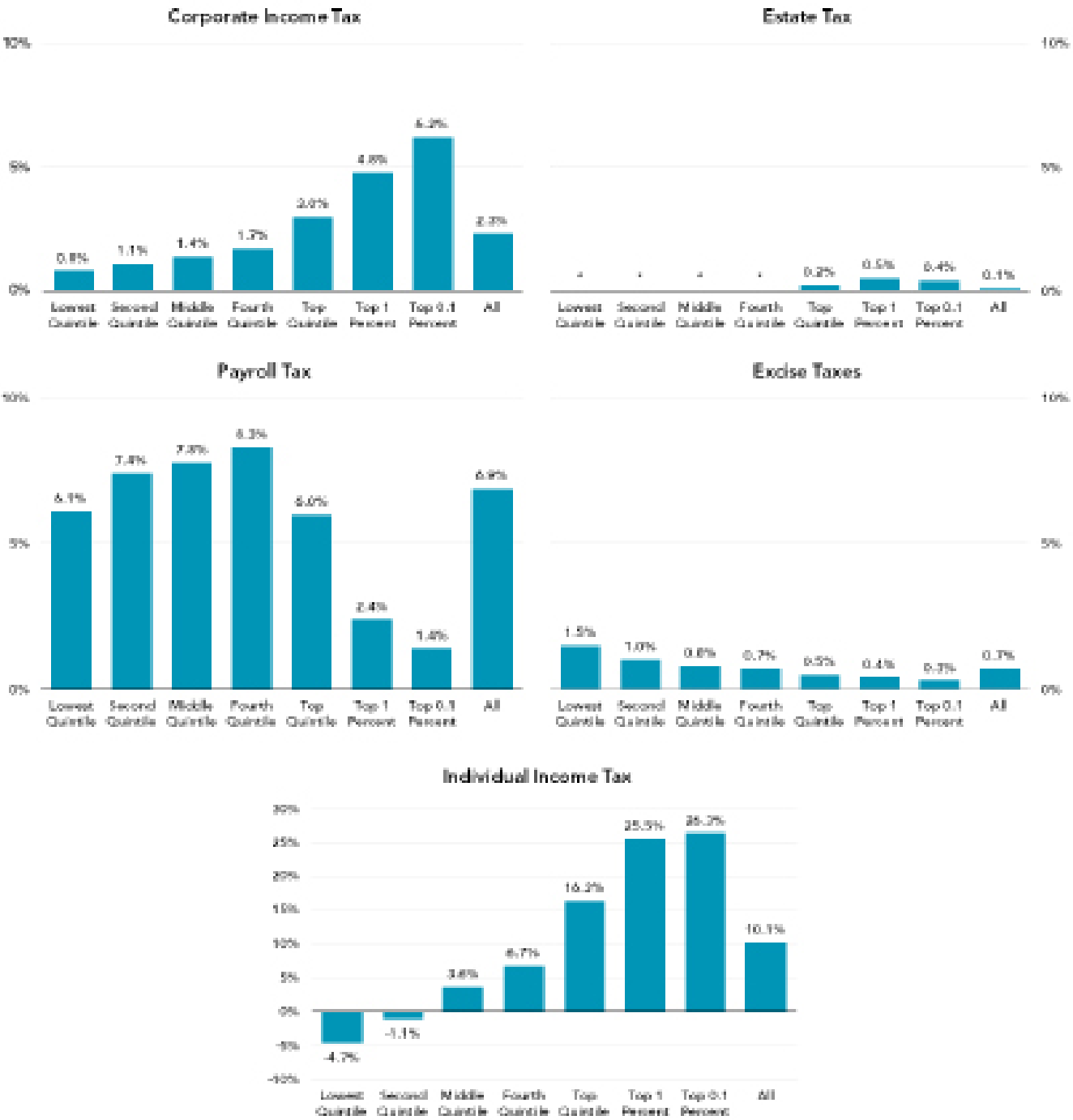
Background

Are federal taxes progressive?

FIGURE 2

Average Effective Tax Rates for Each Federal Tax

By expanded cash income group, 2017



Sources: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Background

Are federal taxes progressive?

INDIVIDUAL INCOME TAX

The individual income tax is progressive, thanks to the impact of refundable credits for lower-income households (average tax rates are negative for the two lowest income quintiles), the standard deduction and personal exemptions (which exempt a minimum level of income from the tax), and a graduated rate structure (rates on ordinary income rise from 10.0 to 39.6 percent, with an additional 3.8 percent marginal tax on certain investment income of high-income households).

CORPORATE INCOME TAX

The corporate income tax is progressive because most of its burden falls on income from dividends, capital gains, and other forms of capital income that are disproportionately received by high-income households.

ESTATE TAX

The estate tax is only imposed on households with high levels of wealth (only wealth in excess of an exemption amount is subject to the tax, and that amount for those who die in 2017 is $5.49 million and effectively double that for married couples). High-wealth is almost always commensurate with high income, so, when households are classified by income, virtually the entire estate tax burden falls on the very highest income households.

PAYROLL TAXES

The regressive nature of payroll taxes stems from two factors. First, the Social Security portion of payroll taxes is subject to a cap: in 2017, individuals will pay the tax on only their first $127,200 in earnings. Second, as a group, higher-income households receive relatively more of their income from sources other than wages, such as capital gains and dividends, which are not subject to the payroll tax. However, because wages rise as a share of income over the first four quintiles of the distribution, payroll taxes are slightly progressive until high-income levels are reached.

Background

Are federal taxes progressive?

EXCISE TAX

An excise tax increases the price of the taxed good or service relative to the prices of other goods and services. So households that consume more of the taxed good or service as a share of their total consumption face relatively more of the tax burden from this change in relative prices. The regressivity of excise taxes is primarily the result of this relative price effect, because, on average, alcohol and tobacco represent a declining share of consumption as household income rises.

Data Sources

Urban-Brookings Tax Policy Center. Table T16-0094. "Effective Federal Tax Rates—All Tax Units, by Expanded Cash Income Percentile, 2017."

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Q. How should progressivity be measured?

A. A broad definition of progressivity, that tax burdens rise with household income, masks a host of ambiguities in measuring the effect of a tax change. The percentage change in after-tax income is the most reliable measure of the progressivity of such a change.

A tax is progressive if, on average, household tax burdens rise with incomes. This definition is generally considered too broad because there are various ways to define "tax burden." Table 1 helps illustrate the problem by analyzing a hypothetical proposal to reduce all individual income tax rates by 1 percentage point.

TABLE 1

Measures of Changes in Federal Tax Burdens due to Proposals to Reduce All Federal Individual Income TaxRates by One Percentage Point[a]

2017

Expanded cash income percentile	Baseline Distribution of Income and Federal Taxes				Measures of Change in Federal Tax Burden Due to Proposal				
	Average pre-tax income (dollars)	Average federal tax burden (dollars)	Percent of federal tax burden	Average federal tax rate (percent)	Average change in tax burden (dollars)	Percentage change in tax burden	Change in percent of burden	Change in average tax rate (% points)	Percentage change in after-tax income
Lowest quintile	14,430	540	0.8	3.7	-10	-1.9	0.0	-0.1	0.1
Second quintile	36,300	3,040	3.7	8.4	-80	-2.6	0.0	-0.2	0.3
Middle quintile	65,510	8,920	9.6	13.6	-270	-3.0	-0.1	-0.4	0.5
Fourth quintile	111,590	19,360	17.6	17.4	-590	-3.0	-0.2	-0.5	0.6
Top quintile	342,890	89,510	68.1	26.1	-1,490	-1.7	0.3	-0.4	0.6
All	89,920	18,040	100.0	20.1	-380	-2.1	0.0	-0.4	0.5
Addendum									
80-90	174,830	35,340	13.9	20.2	-980	-2.8	-0.1	-0.6	0.7
90-95	249,700	55,340	10.4	22.2	-1,130	-2.0	0.0	-0.5	0.6
95-99	413,100	105,150	15.1	25.5	-570	-0.5	0.2	-0.1	0.2
Top 1 percent	2,385,290	797,410	28.7	33.4	-12,700	-1.6	0.1	-0.5	0.8
Top 0.1 percent	11,429,560	3,942,140	14.6	34.5	-54,040	-1.4	0.1	-0.5	0.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

(a) The Proposal would reduce statutory individual income tax rates from 10, 15, 25, 28, 33, 35, and 39.6 percent to 9, 14, 24, 27, 32, 34, and 38.6 percent. The preferential rates on capital gains and dividends and the rates under the Alternative Minimum Tax (AMT) would not be changed.

Background

How should progressivity be measured?

In this example, five possible measures of changes in tax burdens might be used.

1. The average change in tax burden (figure 1.1). This is the change in the average dollar amount of the taxes borne by households in each income group. Because tax reductions increase with income, the proposal would seem to reduce progressivity. But higher-income groups have higher tax burdens before the change, which means that they are not disproportionately better off than lower-income groups even though they receive larger tax cuts under the proposal. Therefore, the average change in tax burden seems an ambiguous measure of progressivity.
2. The percentage change in tax burden (figure 1.2). This is the percentage change in the average dollar amount of the taxes borne by households in each income group. The lowest and highest income groups have the smallest percentage reduction in average tax burdens, implying that the proposal reduces progressivity at the low-income end, and increases progressivity at the high-income end. But the burden that any dollar amount of taxes imposes on a household depends on the household's income; certainly the burden of paying $100 of tax is much greater on a household with $10,000 of income than it is on a household with $1 million. Therefore, the percentage change in tax burden is an inadequate measure of progressivity.
3. The change in percent of tax burden (figure 1.3). This is the change in the percentage distribution of tax burdens across income groups. The change is zero for the "All" income group, because the percentage distributions under baseline (current) law and under the proposal both must add to 100 percent. For the proposal, this measure shows that the share of taxes paid by the top 5 percent of households would increase, while the share would decrease or remain unchanged for all lower-income groups, indicating that the proposal increases progressivity. But an increase in the share of tax burdens for high-income households does not necessarily indicate that high-income households have suffered disproportionately. Therefore, the change in percent of tax burden is not an unambiguous measure of progressivity, either.
4. The change in average tax rate (figure 1.4). Changing tax burdens as a percent of pre-tax income reduces average tax rates the least for the bottom two income quintiles and by roughly the same amount for the top three quintiles. This suggests that the proposal somewhat reduces progressivity, at least at lower income levels. But relative changes in pre-tax income do not indicate how much households' relative well-being—their ability to consume currently or in the future (using savings)—is affected. Therefore, the change in average tax rate is an inadequate indicator of progressivity.
5. The percentage change in after-tax income (figure 1.5). This measure is the change in tax burdens as a percent of after-tax income (i.e., pre-tax income less current tax burdens). The proposal generally increases after-tax incomes by increasing percentages as income increases (with the largest percentage increase for the top 1 percent of households), implying that the proposal reduces progressivity. Because households' current and future consumption from current income can only be made from the amount left after paying taxes, the percentage change in after-tax income provides a direct measure of the effect of a tax proposal on households' welfare. It is therefore the most useful measure of progressivity.

Background

How should progressivity be measured?

FIGURE 1

Measures of Changes in Federal Tax Burdens due to Proposals to Reduce All Federal Individual Income Tax Rates by One Percentage Point[a]
2017

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
[a] The Proposal would reduce statutory individual income tax rates from 10, 15, 25, 28, 33, 35, and 39.6 percent to 9, 14, 24, 27, 32, 34, and 38.6 percent. The preferential rates on capital gains and dividends and the rates under the Alternative Minimum Tax (AMT) would not be changed.

Background

How should progressivity be measured?

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Q. What is the difference between marginal and average tax rates?

A. Average tax rates measure tax burden, while marginal tax rates measure the impact of taxes on incentives to earn, save, invest, or spend.

The average tax rate is the total amount of tax divided by total income. For example, if a household has a total income of $100,000 and pays taxes of $15,000, the household's average tax rate is 15 percent. The marginal tax rate is the incremental tax paid on incremental income. If a household were to earn an additional $10,000 in wages on which $1,530 of payroll tax and $1,500 of income tax was paid, the household's marginal tax rate would be 30.3 percent.

Average tax rates are a measure of a household's tax burden; that is, how taxes affect the household's ability to consume today or (through saving) in the future. Marginal rates measure the degree to which taxes affect household (or business) economic incentives such as whether to work more, save more, accept more risk in investment portfolios, or change what they buy. Higher marginal rates reduce incentives to engage in a particular activity (such as work) or (in the case of sales taxes) consume a particular item.

Data Sources

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Q. What criticisms are levied against standard distributional analysis?

A. Economists disagree on which taxes to include, how to measure tax burdens, what to assume about tax incidence, how to measure income, what period of analysis to use, and whether to include outlays in the calculations.

Distributional analyses of tax burdens across income groups play an important role in debates over the tax system and how to reform it. Differences in the conceptual framework, underlying theoretical assumptions, and empirical implementation can all significantly affect the results of these analyses.

Here are some of the criticisms that have been levied against standard distributional analyses prepared by the Urban-Brookings Tax Policy Center (TPC), the Joint Committee on Taxation (JCT), Treasury's Office of Tax Analysis (OTA) and the Congressional Budget Office (CBO).

TAXES INCLUDED

Analyses often omit certain taxes. For example, TPC used to omit excise taxes, and JCT and CBO omit estate and gift taxes. Many analyses make no provision for the impact of state and local taxes.

HOW TAX BURDENS ARE MEASURED

Households may adjust their behavior to avoid some of the burden of tax changes. JCT uses actual tax payments, which reflects avoidance behavior. But this measure understates the true tax burden because it ignores welfare loss. Conversely, TPC and OTA use a "static" (no behavior) assumption, which overstates true burdens. All groups use projected tax receipts to measure the burden of current law taxes, and these receipts reflect households' behavioral responses, so these burdens are understated. Further, the inclusion of payroll taxes for Social Security and Medicare has been criticized on the grounds that the distributional impact of the associated benefits is omitted.

INCIDENCE ASSUMPTIONS

Uncertainty over the economic incidence of some taxes, especially the corporate income tax, leads some economists to criticize the specific assumptions made in distributional analyses.

Background

What criticisms are levied against standard distributional analysis?

INCOME MEASURE

Income is used in distributional analyses to rank households by their "ability to pay"; it is also used to provide measures of tax burdens such as taxes as a percent of income by income group. These methods are often criticized because differing definitions and measurements of income can significantly affect distributional results.

In theory, a broad definition of income may appropriately rank families and measure tax burdens, but this definition can be too far removed from common understandings of income and difficult to employ because of gaps in available data.

Conversely, even a quite broad definition of income, such as TPC's "expanded cash income", can be criticized as being too narrow because it omits in-kind benefits such as Medicare, Medicaid, and housing assistance, which can be large and significantly improve the well-being of recipient households.

Some argue that consumption, rather than income, should be used to rank households and measure tax burdens. Income is either consumed currently or saved for future consumption. A household's current consumption measures current well-being, while savings will be included in the measure of their well-being in the future, when it is withdrawn to finance consumption. Focusing on current income overstates the well-being of current savers and understates the well-being of current dissavers.

PERIOD OF ANALYSIS

Most distributional analyses focus on a single year, but some tax provisions have effects over multiple years. For example, contributions to a traditional IRA are deductible when made but taxable when withdrawn, and there is no tax on the earnings as they accrue. An annual measure of tax burdens would only capture the effect of the contribution in one of these years, rather than measure the multiyear consequences of the IRA contribution. TPC and OTA use alternative annual measures for some multiyear provisions in their distributional analyses, but these measures rely on uncertain assumptions such as when taxable withdrawals begin and the rate at which to discount taxes paid in the future.

In addition, a tax proposal may have provisions that phase in or phase out over time, or that are only temporary. Such temporal issues have been represented in standard distribution tables in various ways. Economists have prepared analyses for each year (or perhaps the beginning and end year) of a phase-in, phase-out, or temporary provision, or developed methods that reflect the present value of the provision over the budget period. These approaches are all open to criticism.

All four groups use annual income measures, which can be problematic because income is volatile: some normally high-income households will be counted among low-income households in a particular year, while some normally low-income households will appear to have higher incomes. Further, income for most individuals follows a "life-cycle" pattern—generally rising through about age 50 and then declining—so in any particular year, the distribution will underestimate the welfare of the young and old and overestimate the welfare of the middle-aged.

Background

What criticisms are levied against standard distributional analysis?

TAXES VERSUS SPENDING

The federal budget counts amounts paid as refundable credits on the expenditure side of the ledger, but all standard distributional analyses classify those amounts as (negative) taxes. Similarly, all analyses effectively reduce tax burdens by the special exemptions, deductions, tax rates, and credits that represent "tax expenditures," which arguably should be counted as budget outlays rather than as tax reductions. Including these outlays in the analyses understates the true burden of taxes.

Moreover, because standard distributional analyses omit the benefits from most government spending programs, these analyses do not reflect the overall effect of the federal budget on the well-being of households.

EFFECTS ON THE DEFICIT AND SPENDING

All four groups ignore the effects of financing a tax cut, be it through reductions in current outlays or higher deficits or higher debt (which eventually will require future tax increases or reductions in spending to repay). They also omit opposite effects of a tax increase.

MACROECONOMIC EFFECTS

All four groups assume for purposes of distributional analyses that any tax change leaves economic aggregates (GDP, employment, the price level, etc.) unchanged. Critics argue that tax reform could improve economic performance, and thereby raise revenues while improving the well-being of many (if not all) households.

OTHER DIMENSIONS OF TAX POLICY

A frequent criticism of distributional analyses is that they focus on only one dimension of tax policy: vertical equity (fairness across income groups). Less attention is therefore paid to horizontal equity (fairness within income groups), simplification, economic efficiency, and the ability of the tax system to finance worthy federal spending.

Background

What criticisms are levied against standard distributional analysis?

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Q. How should distributional tables be interpreted?

A. Distributional tables provide important and useful information, but here are six key things to keep in mind to correctly interpret the results.

1. What taxes or tax changes are included in the analysis? If the table covers taxes under current law, note which taxes are included and which aren't. If the table shows the distributional impact of a tax change, particularly an extensive reform proposal, be sure to note which provisions are included or omitted.
2. What is the baseline for a tax change? Ordinarily, the baseline is current law, but that is not always the case. Before the permanent tax changes in the American Taxpayer Relief Act of 2012 (ATRA), economists were uncertain about what "current law" would look like in the future. As a result, some distribution tables used "current policy" —implicitly assuming that Congress would extend tax provisions set to expire or would allow them to sunset—as the baseline.
3. What is the income measure? Income is used in distributional tables to rank households by their "ability to pay"; it is also used to provide measures of tax burdens such as taxes as a percentage of income by income group. Definitions and measurements of income can significantly affect distributional results, so be sure to note which income measure is used. Also, income used to rank households may be adjusted for family size to provide a better comparison of ability to pay across households.
4. What are the household units? Note whether the table includes the population in households that do not file income tax returns. Some distributional tables that rank by quintiles of income typically place a fifth of all households in each quintile. But some tables—including those produced by the Tax Policy Center—place a fifth of the population in each quintile, altering the count of household units in each quintile.
5. What period is covered? Standard distribution tables cover a single year. But some policy changes may have effects over multiple years, and some may be phased in or phased out over multiple years, or be only temporary. Note the way in which any phase-ins, phaseouts, and temporary provisions are represented.
6. What measures of tax burdens are included? Distribution tables typically show alternative measures of "tax burdens." However, only the percentage change in after-tax income directly measures the effect of a tax proposal on households' well-being and therefore is a reliable measure of progressivity.

Background

How should distributional tables be interpreted?

Further Reading

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Joint Committee on Taxation. 2015. "Fairness and Tax Policy." JCX-48-15. Washington, DC: Joint Committee on Taxation.

Q. Who bears the burden of the corporate income tax?

A. The burden is shared among stockholders and, unintuitively, among a broader group of workers and investors.

Shareholders bear some of the corporate income tax burden, but they aren't the only ones. Over time, others bear some of the burden because of a chain reaction that begins with the shareholders.

The corporate income tax reduces after-tax returns for shareholders, causing them to shift some of their investments out of the corporate sector. Some investments are shifted to noncorporate ("pass-through") businesses and some to non-US businesses that are not subject to the US corporate income tax. The shift to these other sectors lowers the after-tax return on investments in these sectors. The shifting of investment out of the corporate sector continues until after-tax returns—adjusted for risk—are equalized in the corporate and noncorporate sectors. Thus, the corporate income tax reduces investment returns in all sectors.

Shifting investments to non-US businesses also reduces the amount of capital (machines, equipment, structures, etc.) complementing US workers, so their productivity, and therefore their wages and other compensation fall.

In calculating distributional effects, the Tax Policy Center (TPC) assumes 80 percent of the burden is borne by investment returns (dividends, interest, capital gains, etc.), with the remaining 20 percent weighing on wages and other labor income. These assumptions reflect the full, long-term economic consequences of investors responding to changes in the corporate income tax, such as rate changes.

When analyzing the distributional effects of a short-term corporate income tax change before investors have a chance to react, TPC assumes that the entire burden is borne by shareholders. When analyzing corporate income tax changes that affect only the timing of payments, such as a change in depreciation allowances, TPC assumes that half the burden is on investment returns and half on wages and other labor income. The Joint Committee on Taxation, Treasury's Office of Tax Analysis, and the Congressional Budget Office use similar incidence assumptions.

Background

Who bears the burden of the corporate income tax?

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Q. Who bears the burden of federal excise taxes?

A. Workers, owners of capital, and households that consume a disproportionate amount of taxed items all bear the burden of federal excise taxes.

Excise taxes create a wedge between the price paid by the final consumer and what is received by the seller. An excise can either raise the total price (inclusive of the excise tax) paid by consumers or reduce the amount of business revenue available to compensate workers and investors.

The burden of an excise can be separated into two pieces: (1) the reduction in real household income, which in total is equal to the gross revenue generated by the excise tax, and (2) the increase in the price of the taxed good or service relative to the prices of other goods and services, which depends on the relative mix of consumption by each household and is equal to zero across all households. Note that the decline in real income is the same regardless of whether nominal incomes fall (holding the price level constant) or whether the price level rises (holding nominal incomes constant).

REDUCTION IN REAL INCOME

The reduction in real income is spread across wages, profits, and other returns to labor and capital. The reduction in wages in turn reduces both individual income taxes and payroll taxes. Likewise, the reduction in profits reduces corporate income taxes and individual income taxes on the profits of pass-through business (like partnerships) and other returns to capital. These "excise tax offsets" amount to about 25 percent of excise tax revenues and are taken into account in distributional analyses.

CHANGE IN RELATIVE PRICES

An excise tax also increases the price of the taxed good or service relative to the prices of all other goods and services. While the price of the taxed item rises, the prices of all other items may either remain unchanged, as the overall price level rises, or may fall slightly if the price level remains unchanged. Either way, this change in relative prices burdens households that consume a larger than average share of the taxed item. However, households that consume a smaller than average share of the taxed item, or do not consume it at all, benefit from this change in relative prices.

TIMING OF THE TAX BURDEN

This still leaves open the issue of the timing of the tax burden—that is, whether the burden is assigned when income is earned or when it is consumed. Some distributional analyses follow the latter approach and distribute excise taxes in proportion to current levels of consumption. Alternative analyses assign the burden based

on current income. Under the income-based approach, one can think of excise taxes as a reduction in purchasing power at the point income is earned. Of course, if all households fully consumed their income in each year, the two methods would yield identical results.

The Urban-Brookings Tax Policy Center distributes the burden of an excise tax when income is earned, taking into account the "offset" and the relative price effect. The US Department of the Treasury's Office of Tax Analysis, as described in Cronin (1999), distributes excise taxes in the same manner. The Joint Committee on Taxation and the Congressional Budget Office, however, distribute the entire burden of excises in proportion to consumption of the taxed goods and services.

DISTRIBUTION OF FEDERAL EXCISE TAXES

While the share of federal excise tax paid rises with incomes, federal excises are regressive as the average federal excise tax rate (the excise tax burden as a percentage of pre-tax income) declines as income rises. The average tax rate falls from 1.5 percent in the bottom quintile, to 0.5 in highest quintile, and to 0.3 percent of income in the top 1 percent. (Each quintile contains 20 percent of the population, ranked by income.) Federal excise taxes are over 40 percent of the total federal tax burden (including individual and corporate income taxes, payroll taxes, the estate tax, and excise taxes) in the bottom quintile and over 12 percent in the second income quintile (table 1).

Federal excise tax revenues totaled $98.3 billion in fiscal year 2015, or 3.0 percent of federal tax revenues. Five categories of excise taxes—highway, tobacco, air travel, health, and alcohol—accounted for about 90 percent of total excise tax receipts in that year.

TABLE 1

Distribution of Federal Excise Taxes, 2017

Cash Income Percentile	Excise Tax Burden		
	Share of Total (percent)	Average Tax Rate (percent)	Percent of Total Federal Burden (percent)
Lowest Quintile	9.7	1.5	40.7
Second Quintile	13.1	1.0	12.1
Middle Quintile	16.7	0.8	6.0
Fourth Quintile	21.1	0.7	4.1
Top Quintile	39.0	0.5	2.0
All	100.0	0.7	3.4
Addendum			
80-90	12.8	0.6	3.2
90-95	8.1	0.6	2.7
95-99	9.5	0.6	2.2
Top 1 percent	8.6	0.4	1.0
Top 0.1 percent	3.5	0.3	0.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Background

Who bears the burden of federal excise taxes?

The distributional burden varies somewhat across the different categories of excise taxes (table 2). The most noticeable is the tobacco excise tax, for which the share of tax paid is nearly constant across income quintiles. The bottom quintile pays 18.4 percent of tobacco taxes and 23.7 percent of penalties under the Affordable Care Act (ACA) (compared to 4 to 5 percent of other excises), while the top quintile pays just 26.3 percent of tobacco taxes and 18.8 percent of ACA penalties (compared to about 45 to 50 percent of other excises). Tobacco taxes and ACA penalties are the most regressive of the major federal excise taxes. The remaining categories vary only modestly. Excise taxes on air travel are tilted the most toward higher income households, with 52.4 percent of these excises paid by households in the top income quintile.

TABLE 2

Distribution of Federal Excise Taxes by Category, 2017

Cash Income Percentile	Share of Total Excise Tax Burden by Category						
	Highway	Tobacco	Air travel	Health	ACA Penalties	Alcohol	Other
Lowest Quintile	4.4	18.4	4.2	4.1	23.7	4.6	4.8
Second Quintile	10.7	18.4	7.4	10.5	21.8	9.2	9.9
Middle Quintile	17.0	17.1	14.3	16.4	18.4	17.2	15.6
Fourth Quintile	22.9	19.4	21.2	23.1	16.9	23.0	22.1
Top Quintile	44.6	26.3	52.4	45.4	18.8	45.9	47.3
All	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Addendum							
80-90	14.4	8.4	15.9	14.5	8.0	14.8	14.7
90-95	8.8	4.3	11.6	9.2	4.8	10.0	9.7
95-99	10.8	5.7	13.5	11.0	4.5	11.2	11.5
Top 1 Percent	10.6	7.9	11.5	10.7	1.5	9.9	11.3
Top 0.1 Percent	4.4	3.8	4.5	4.4	0.2	4.1	4.6
Memo: Aggregate Revenue ($ billions)	*$41.0*	*$13.7*	*$15.2*	*$4.0*	*$20.7*	*$10.2*	*$3.7*

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Data Sources

Urban-Brookings Tax Policy Center. Table T16-0094. "Effective Federal Tax Rates—All Tax Units, by Expanded Cash Income Percentile, 2017."

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Q. How do financing methods affect the distributional analyses of tax cuts?

A. Tax cuts are financed through reductions in current outlays or higher government debt that will eventually have to be repaid. Distributional analyses omit this information as well as the effects of tax increases on current outlays and debt.

Distributional analyses omit the ways tax cuts and tax increases affect other government finances—either through lower (or higher) spending or higher (or lower) debt. These omissions implicitly assume that lost revenue from tax cuts is never paid for, and that additional revenue from tax increases simply disappears. No one believes these assumptions are realistic, but there is no generally accepted way to include these financing effects. Burman (2007) shows that the distributional effects of the 2001-06 tax cuts are significantly altered if alternative financing effects are taken into account.

Further Reading

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Background

What are tax expenditures and how are they structured?

Q. What are tax expenditures and how are they structured?

A. Tax expenditures are special provisions of the tax code such as exclusions, deductions, deferrals, credits, and tax rates that benefit specific activities or groups of taxpayers.

The Congressional Budget Act of 1974 defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." These provisions are meant to support favored activities or assist favored groups of taxpayers. Thus, tax expenditures are alternatives to direct spending programs or regulations to accomplish the same goals. The Office of Management and Budget (OMB) and the Congressional Joint Committee on Taxation (JCT) each year publish lists of tax expenditures and estimates of their associated revenue losses. The Treasury Department prepares the estimates for OMB.

The key word in the definition of tax expenditures is "special." OMB and JCT do not count all exemptions and deductions as tax expenditures. For example, the agencies do not count as tax expenditures deductions the tax law permits to measure income accurately, such as employers' deductions for employee compensation or interest expenses. Similarly, OMB and JCT do not count personal and dependent exemptions as tax expenditures on the theory that adjusting for family size is appropriate in measuring a taxpayer's ability to pay.

More generally, both the decision to count a provision as a tax expenditure and the measurement of its size require that OMB and JCT define a normative or baseline system against which some provisions are exceptions. Both agencies include in the baseline system provisions that allow tax rates to vary by income, that adjust for family size and composition in determining taxable income, and that allow for a separate tax on corporate income. The baselines of the two agencies do differ in some details, however, which contribute to differences in their lists of provisions and their estimates of revenue losses.

Background

What are tax expenditures and how are they structured?

TAX EXPENDITURES TAKE DIFFERENT FORMS

Deductions and exclusions reduce the amount of income subject to tax. Examples are the deduction for mortgage income on personal residences and the exclusion of interest on state and local bonds. Deductions and exclusions reduce tax liability more for higher-income taxpayers facing higher marginal income tax rates than for lower-income taxpayers in lower rate brackets.

A special category of deductions, called itemized deductions, is valuable only to taxpayers whose sum of itemized deductions exceeds the standard deduction amounts available to all tax filers. The largest itemized deductions are those for home mortgage interest, state and local nonbusiness taxes, and charitable contributions. In 2014, only 30 percent of tax returns claimed itemized deductions.

Credits reduce tax liability dollar for dollar for the amount of credit. For example, the child tax credit reduces liability by $1,000 per child for taxpayers eligible to use it fully. A special category of credits, called refundable credits, allows taxpayers to claim credits that exceed their positive income tax liability, thereby receiving a net refund from the IRS. The major refundable credits are the earned income tax credit and the health insurance premium assistance tax credit, which are fully refundable, and the child credit, which is refundable for those with earnings above a threshold amount.

Some forms of income benefit from preferential rates. For example, long-term capital gains and qualified dividends face a schedule of rates ranging from 0 to 20 percent, compared with rates on ordinary income, which range from 10 to 39.6 percent.

Finally, some provisions allow taxpayers to defer tax liability, thereby reducing the present value of taxes they pay, either because the taxes are paid later with no interest charge or because they are paid when the taxpayer is in a lower rate bracket. These provisions allow taxpayers to claim deductions for costs of earning income before the costs are incurred. Examples include provisions that allow immediate expensing or accelerated depreciation of certain capital investments, and others that allow taxpayers to defer their tax liability, such as the deferral of recognition of income on contributions to and income accrued within qualified retirement plans.

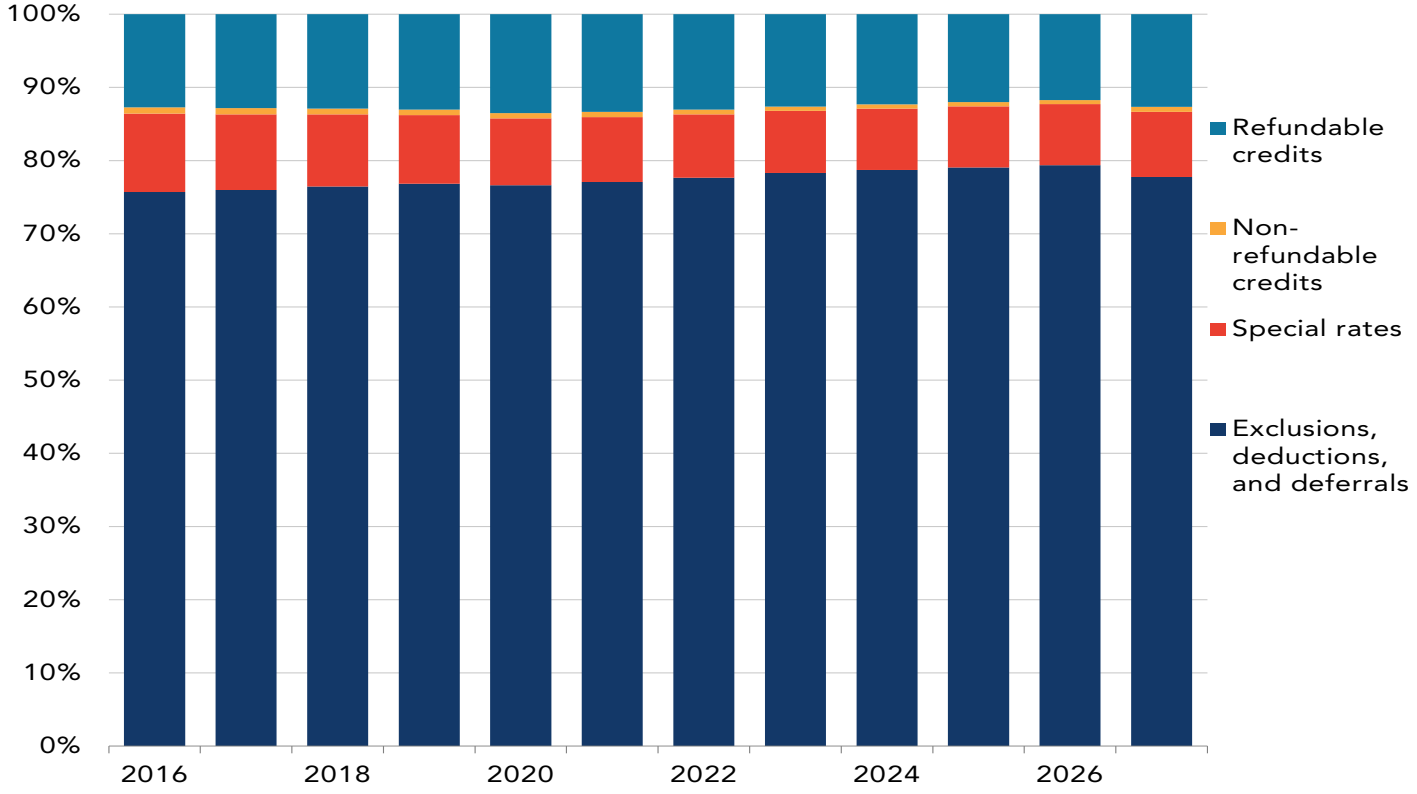
Exclusions, deductions, and deferrals of income recognition will account for 77 percent of individual income tax expenditures in fiscal year 2018, special rates for 10 percent, nonrefundable credits for 1 percent, and refundable credits for 13 percent (figure 1).

Background

What are tax expenditures and how are they structured?

FIGURE 1

Shares of Individual Income Tax Expenditures, 2016-26



Source: US Department of the Treasury. Tax Expenditures 2017. Table 1.

Data Source

US Department of the Treasury. Tax Expenditures 2017. Table 1. "Estimates of Total Individual Income Tax Expenditures for Fiscal Years 2016–2026."

Q. What is the tax expenditure budget?

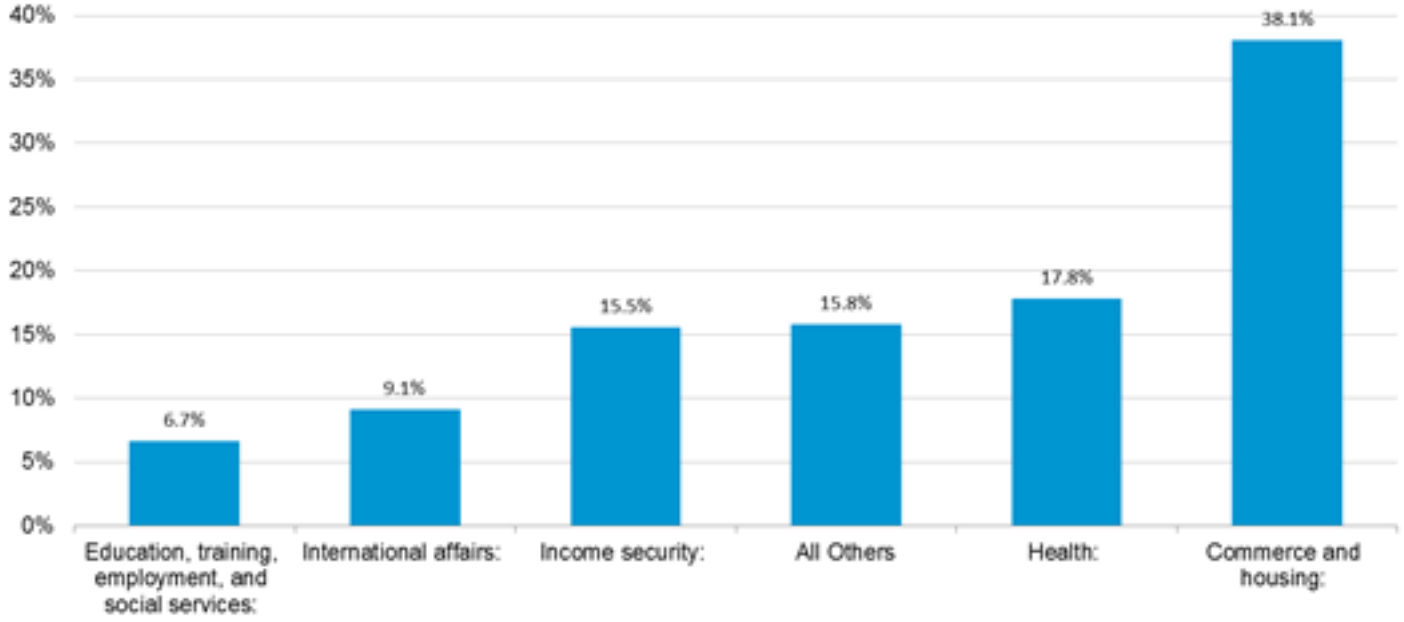
A. It displays the estimated revenue losses from special exclusions, exemptions, deductions, credits, deferrals, and preferential tax rates in federal income tax law.

Every year, the Office of Management and Budget (OMB) and the Congressional Joint Committee on Taxation (JCT) publish lists of tax expenditures. These lists, sometimes called the Tax Expenditure Budgets, enumerate the estimated revenue losses attributable to preferences in the tax code the agencies describe as exceptions to "normal" or "reference" provisions of the income tax law (figure 1).

FIGURE 1

Tax Expenditure Budget

Share of total tax expenditures by category, FY 2018



Source: US Department of the Treasury, Office of Tax Policy, 2016. Tax Expenditures – FY 2018. Table 1.
Notes: The "All Other" category includes the following: general purpose fiscal assistance, social security, general science, space and technology, national defence, veterans benefits and services, energy, transportation, community and regional development, agriculture, natural resources and

Background

What is the tax expenditure budget?

Tax expenditures reduce the income tax liabilities of individuals and businesses that undertake activities Congress specifically encourages. For example, the deduction for charitable contributions reduces tax liability for people who donate to qualifying charitable organizations. Tax expenditures can also reduce tax liability for individuals Congress wishes to assist. For example, a portion of Social Security benefits received by retired or disabled people is exempt from federal income tax.

The Congressional Budget Act of 1974 requires that the budget include estimates for tax expenditures, but only for provisions that affect the federal income taxes of individuals and corporations. The government could, but does not, provide lists of tax expenditures for payroll taxes, excise taxes, and other taxes, although OMB does estimate (in footnotes) the effects on payroll tax receipts of income tax expenditures.

Both the Office of Tax Analysis (OTA) in the Treasury and the JCT estimate tax expenditures annually. The items included in each, along with their estimated values, are generally similar but do not always match. OMB publishes OTA's estimates in its Analytical Perspectives volume that accompanies each year's Budget of the U.S. Government.

The budget generally treats tax expenditures as revenue losses instead of as spending. An exemption is made for the portion of refundable tax credits that exceeds individuals' positive income tax liabilities. Here, the net refunds are counted as spending. OMB's tables show only the revenue losses of tax expenditures, while JCT's tables include both the revenue loss and outlay effects of refundable credits. Both OMB and JCT display the outlay effects in footnotes.

OMB's tax expenditures for fiscal 2018, including outlay effects, added up to more than $1.5 trillion. The combined revenue loss for all provisions does not necessarily equal the sum of the losses for each provision because of how the provisions interact. For example, eliminating one exemption from taxable income would push taxpayers into higher rate brackets, thereby increasing revenue loss from remaining exemptions. Toder, Berger, and Zhang (2016) thus estimate that the actual combined revenue loss from all individual tax expenditures is about 6 percent larger than the amount computed by summing individual tax expenditures—though for one subcategory, itemized deductions, the total revenue loss is less than the sum of losses from the separate deductions.

Some tax expenditures effectively function like direct expenditures even though they appear as tax breaks, because programs with similar effects could be structured as outlays (Burman and Phaup, 2011). An example is the tax credit for renewable energy investment, which could be structured as grants from the Department of Energy. Other expenditures have no direct spending analogy, but can instead be viewed as departures from an income tax with a comprehensive base. Marron and Toder (2013) estimate that provisions that could be viewed as spending substitutes have recently amounted to over 4 percent of GDP.

Background

What is the tax expenditure budget?

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 and are available with no budget ceiling to all who qualify. Expenditure costs change with the growth of the economy, changes in the quantities and prices of subsidized activities, and—for some provisions—changes in marginal tax rates applied to individual and corporate income. For example, the cost of the mortgage interest deduction varies with the volume of home mortgage debt outstanding, the level of interest rates, and marginal tax rates applied to the taxable income of borrowers.

Data Sources

US Department of the Treasury, Office of Tax Policy, 2016. Tax Expenditures – FY 2018. Table 1.

Further Reading

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Toder, Eric J., Daniel Berger, and Yifan Zhang.. 2016. "Distributional Effects of Individual Income Tax Expenditures: An Update." Washington, DC: Urban-Brookings Tax Policy Center.

Q. Why are tax expenditures controversial?

A. Because they operate very much like spending programs but are hidden in the tax code. Indeed, providing benefits through tax expenditures gives the appearance of reducing the size of government without actually doing so. But identifying and measuring tax expenditures requires assumptions about what the baseline tax system would look like.

To some, tax expenditures are spending items that do not belong in the tax code. To others, they are merely are a way of reducing taxes, and repealing them would amount to a tax increase.

Tax expenditures perform very much like spending programs, which means they may serve or harm the public depending on whether they serve a legitimate public purpose in the most efficient manner possible. But the identification and measurement of tax expenditures is controversial.

Subsidies and expenditures in the form of tax breaks reduce net tax revenue instead of increasing measured spending. Thus they give the appearance of reducing government's size. For this reason, tax subsidies have strong political appeal. In fact, tax expenditures are an alternative way for government to intervene in the economy and, like direct spending, must be paid for through higher taxes or reduced spending elsewhere.

Imagine, for instance, a new government program that provides tax credits for energy production at a cost of $5 billion per year, and finances it by raising income tax rates. To pay for the energy tax credit, it would have to raise tax rates enough to collect an additional $5 billion—no different than what it would need to do if the subsidies for energy production were provided by a Department of Energy grant instead of by tax credits.

Here's the conceptually tricky part: tax expenditures are defined as deviations from a baseline tax system. In the example above, it is straightforward to see the equivalence between an energy tax credit and a spending program. Often, however, the definition and estimated magnitude of tax expenditures is a matter of judgment because what belongs in the baseline tax system itself reflects the judgment of analysts. Since the government began regular reporting of tax expenditures in the 1970s, the baseline against which tax expenditures are measured has been a version of a comprehensive income tax. But there have always been exemptions for income deemed too difficult to assess, such as unrealized capital gains or imputed rental income on owner-occupied housing. Recently, however, the Treasury Department, but not the Joint Tax Committee, has added imputed rental income to its baseline used for estimating tax expenditures.

Background

Why are tax expenditures controversial?

If the current income tax were replaced wholly or partly by a consumption tax, as some economists and political leaders favor, some provisions now classified as tax expenditures would no longer be regarded as such. For example, under a comprehensive consumption tax system, the deferral of earnings contributed to retirement savings accounts and the exemption of income earned within those accounts would not be considered tax expenditures. Most other tax expenditures, however, including the deductibility of home mortgage interest, charitable contributions, and state and local taxes, and the exemption of employer contributions to health insurance plans would still be so classified.

In other cases, estimating the size of a tax expenditure becomes a matter of judgment. For example, under an income tax, firms can recover the costs of capital investment over time with depreciation deductions that reflect the decline in the value of their assets. But what is the right measure of depreciation in an inflationary economy? For these and other items, Congress' Joint Committee on Taxation and the Treasury department use different definitions of what would be included in a normal or comprehensive income tax. Therefore their classification and measurement of some tax expenditures differ.

Data Sources

Office of Management and Budget. Budget of the U.S. Government, FY 2017, Analytical Perspectives, Table 14-1.

Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2015–2019, JCX-141R-15, December 7, 2015.

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Q. What are the largest tax expenditures?

A. 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.

Table 1 ranks the top 13 US tax expenditures. The largest (an estimated $235.8 billion in 2018) is the exclusion of employers' contributions for employees' medical insurance premiums and medical care. Under this provision of the tax code, contributions are excluded from an employee's gross income, while an employer may deduct the cost as a business expense.

The next largest tax expenditure ($112.7 billion in 2018 is the exclusion of net imputed rental income, which is the return on housing equity in the form of rent-free housing. This is one of several tax preferences that focus on housing. Others include the home-mortgage interest deduction ($68.1 billion), the deduction for nonbusiness property taxes as part of the deductibility of nonbusiness state and local taxes ($63.3 billion), and the exemption of the first $500,000 of capital gains for couples ($250,000 for singles) on the sale of principal residences ($48.5 billion).

In general, tax expenditures for individuals are larger than tax expenditures for businesses. Only two business tax expenditure that made it into the list of the top 13: the deferral of income from controlled foreign corporations ($112.6 billion in 2018) and accelerated depreciation of certain machinery and equipment ($50.3 billion in 2018). Among other business tax expenditures, the largest in 2018 are the deduction for US production activities ($17.2 billion), the credit for low-income housing expenditures ($8.9 billion), and the expensing of research and experimentation outlays ($7.7 billion).

Over the 10-year budget horizon, one of the larger tax expenditures is the provision that allows for accelerated depreciation of certain machinery and equipment. This provision allows companies to defer the payment of tax by deducting the cost of equipment over a shorter time period than the property's likely economic life. The figures on accelerated depreciation illustrate how computations of annual revenue losses do not accurately measure the amount of subsidy a tax expenditure actually provides when the provision operates mostly

Background

What are the largest tax expenditures?

TABLE 1

Largest Tax Expenditures

Billions of dollars, FY 2018

Rank	Tax expenditure	Billions ($)
1	Exclusion of employer contributions for medical insurance premiums and medical care	235.8
2	Exclusion of net imputed rental income	112.7
3	Deferral of income from controlled foreign corporations (normal tax method)	112.6
4	Capital gains (except agriculture, timber, iron ore, and coal)	108.6
5	Defined benefit employer plans	71.0
6	Defined contribution employer plans	69.4
7	Mortgage interest expense on owner-occupied residences	68.1
8	Earned income tax credit[a]	63.6
9	Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	63.3
10	Child credit[b]	54.3
11	Step-up basis of capital gains at death	54.1
12	Deductibility of charitable contributions, other than education and health	51.2
13	Accelerated depreciation of machinery and equipment (normal tax method)	50.3

Sources: US Department of the Treasury, Office of Tax Policy. 2016. Tax Expenditures – FY2018. Table 3; and author's addition of outlays for refundable credits.
(a) Includes outlays of $61.8 billion.
(b) Includes outlays of $29.6 billion.
(c) Includes outlays of $40.6 billion.

by changing the timing of tax liability. For this reason, OMB also publishes a table showing the "present value" of tax benefits from a single year's use of selected provisions.

The fourth largest tax expenditure in 2018 is the preferential rate structure for individuals' capital gains income ($108.6 billion), which is taxed at rates ranging from 0 to 20 percent compared to individual income tax rates that range from 10 to 39.6 percent. Capital gains also benefit from the step up in basis at death ($54.1 billion in 2018), which permanently exempts all unrealized capital gains accrued during an individual's lifetime on assets that are passed on at death.

Background

What are the largest tax expenditures?

Retirement saving also benefits from very large tax expenditures. Investment income earned within tax-qualified saving accounts is tax free. In addition, with most tax-qualified retirement saving accounts, the tax on contributions is deferred until withdrawal at retirement, when a taxpayer is usually in a lower tax bracket. The revenue losses from this preference in 2016 are estimated to total $71.0 billion for "defined-contribution" plans such as individual retirement accounts and 401(k) plans, and $69.4 billion for traditional defined-benefit plans sponsored by employers. In comparison, the present value costs of these provisions from contributions in 2016 are over $82 billion for defined contribution plans and only about $30 billion for defined benefit plans. The differences reflect the switch over time from defined benefit to defined contribution plans, so the present value of the cost of this year's contributions are relatively smaller for defined benefit plans than their current revenue loss, which reflect revenue losses from assets in older plans.

Two of the largest tax expenditures mainly benefit low- and middle-income families: the earned income credit ($63.6 billion in 2018) and the child credit ($54.3 billion in 2018). Most budgetary costs from these provisions come from the portion of the credits that exceed income tax liability and are counted as spending in federal budget totals.

The Office of Management and Budget (OMB) divides deductions of charitable contributions into three buckets: donations to nonprofit educational institutions, to nonprofit health institutions, and to all other organizations. The third, catch-all category benefits from a $51.2 billion tax expenditure. Combining the deductions for all three categories would raise its ranking in table 1.

Data Sources

US Department of the Treasury, Office of Tax Policy, 2016. Tax Expenditures – FY 2018. Table 3 and table 4.

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Q. What is the tax gap?

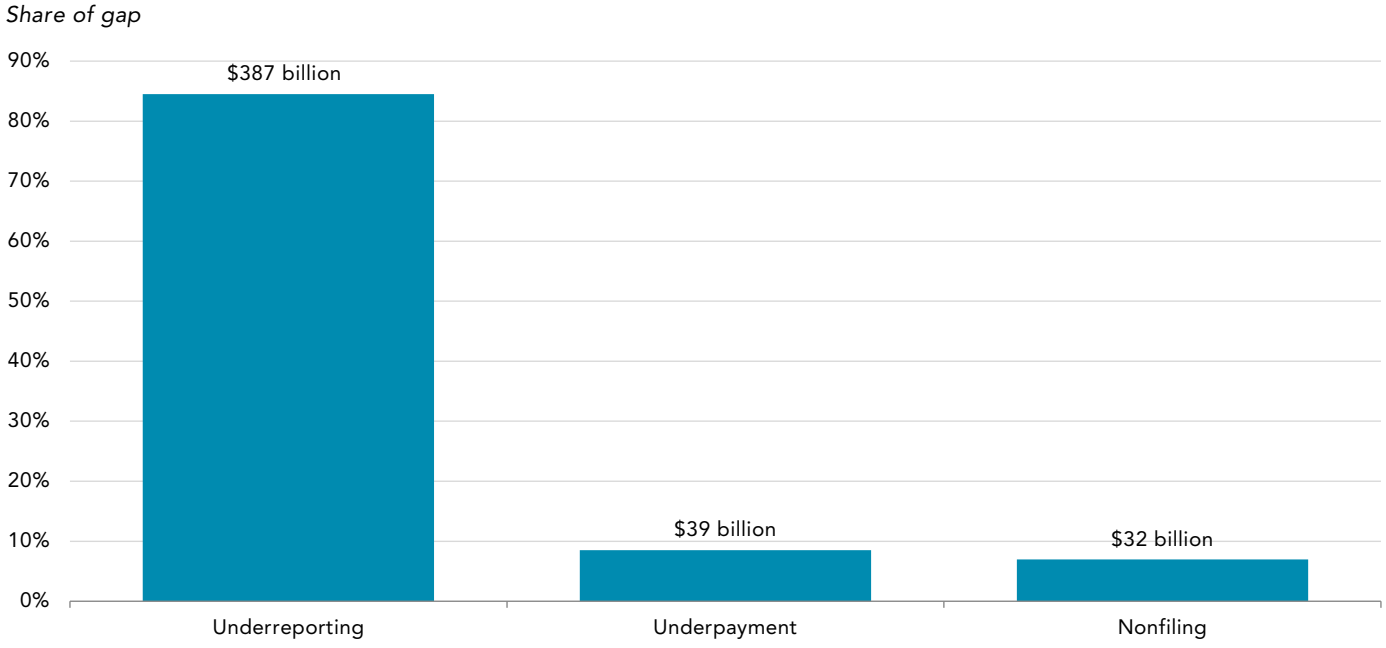
A. The gross tax gap is the difference between total taxes owed and taxes paid on time.

OVERVIEW

The Internal Revenue Service (IRS) estimates that over the past 30 years, the tax gap has ranged from 16 to 20 percent of total tax liability. Some view the tax gap as a major revenue source that could be used to close the federal budget deficit without raising taxes. In practice, though, the potential revenue gains from proposals to improve enforcement are quite limited.

FIGURE 1

Components of the $458 Billion Gross Tax Gap
2008-10



Source: Internal Revenue Service.

Background

What is the tax gap?

2008-10

The latest IRS tax gap report was prepared in 2016 and covered tax years 2008-10. (IRS Research, Analysis, and Statistics, 2016). For those years, the IRS reported a $458 billion gross tax gap (slightly over 18 percent of tax liability), of which $52 billion was eventually recovered through voluntary late payments and enforcement activities. That left a net tax gap of about $406 billion.

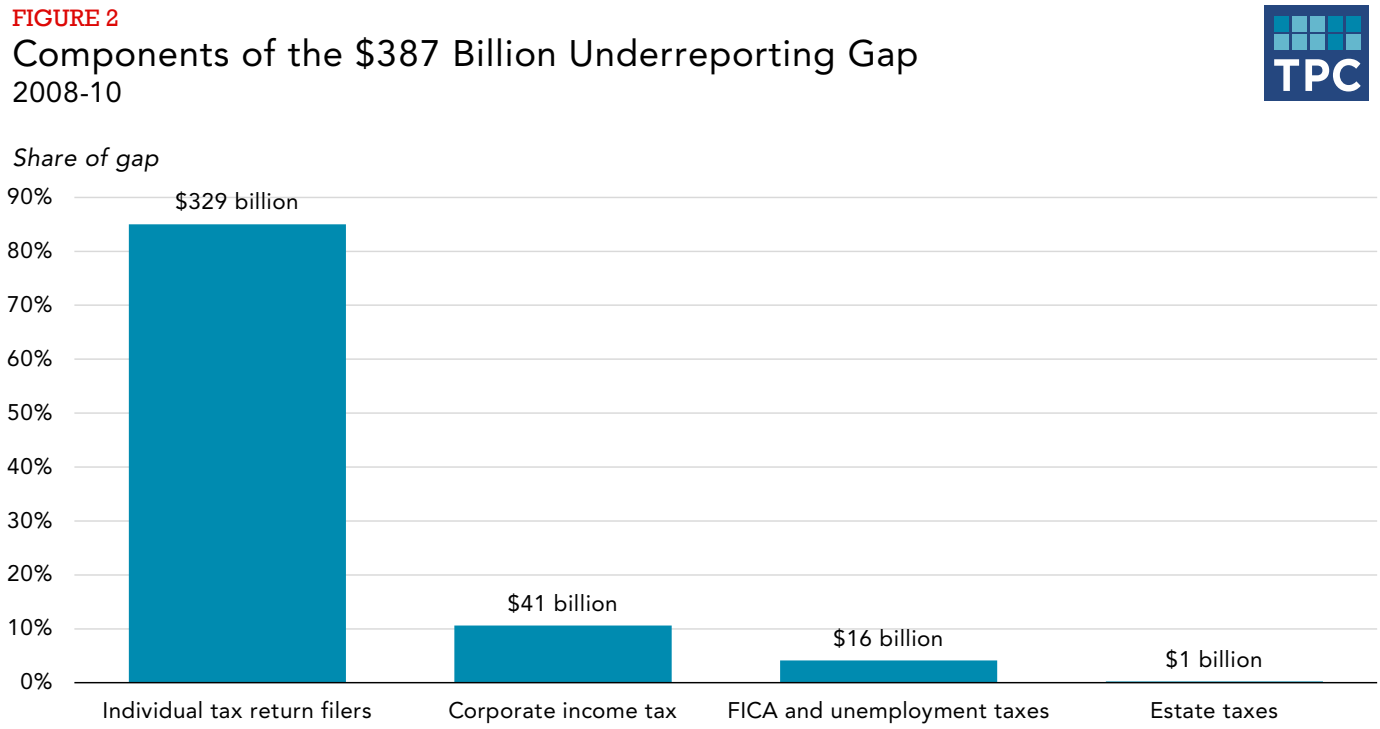
Nonfiling and underpayment of reported taxes account for just over 15 percent of the gross tax gap (figure 1); underreporting on timely filed tax returns makes up the bulk of it; $387 billion or 85 percent of the gross tax gap.

Underreporting on individual income tax returns alone (including self-employment tax) was $329 billion (figure 2); about 85 percent of the underreporting tax gap in 2008-10. Almost 60 percent of the underreported individual tax is owed on business and self-employment income, which the IRS has no easy way to verify independently. About 11 percent of the underreporting gap is attributable to corporate income tax, and only 0.3 percent to the estate tax.

FIGURE 2

Components of the $387 Billion Underreporting Gap

2008-10



Source: Internal Revenue Service.

Background

What is the tax gap?

Individual taxpayers fail to report about 63 percent of income from sources for which there is no information reporting, such as sole proprietorships. In contrast, only 7 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, only about 1 percent goes unreported.

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Background

What is a tax shelter?

Q. What is a tax shelter?

A. Tax shelters are ways individuals and corporations reduce their tax liability. Shelters range from employer-sponsored 401(k) programs to overseas bank accounts.

OVERVIEW

"Tax shelter" is often used as a pejorative term, but it is only a legal way to reduce tax liabilities. Someone who thinks a feature of the tax code giving taxpayers the right to reduce taxes is not a good idea will label it a shelter. Someone else might call that feature of the tax code an incentive.

Individuals and corporations can reduce their final tax liabilities by allocating some proportion of their incomes in tax shelters. Although they are classically associated with incredibly wealthy households and corporations with anonymous Swiss bank accounts, tax shelters are more accessible and widespread than the usual association may suggest. For example, employer-sponsored 401(k) programs and individual retirement accounts are widespread and accessible ways individuals can "shelter" some of their income from taxation.

EFFECTS

Tax shelters are mostly beneficial when considered at the individual and firm levels. Some tax shelters may even be desirable despite their distortionary effects (namely, the substantive burden placed on the tax system, primarily through tax base erosion). Although the erosion of the tax base may be an acceptable loss for largely beneficial tax shelters (e.g., charitable contributions), some tax shelters have little to no benefits or are even harmful. For example, some individuals and firms are able to store wealth in offshore accounts, usually located in countries with advantageous tax rates or laws. According to Gabriel Zucman (2015), approximately $1,200 billion of wealth was stored in offshore tax havens in 2014, resulting in a tax revenue loss of around $35 billion.

Beyond eroding the tax base, tax shelters can have a host of other distortionary effects. For example, corporate wealth stored in offshore tax havens cannot be repatriated to the US without incurring the tax burden the corporation was trying to avoid. This inability to access wealth may drive firms to seek more debt financing, and can depress valuation on the market.

Background

What is a tax shelter?

ABUSIVE TAX SHELTERING

The Internal Revenue Service makes a distinction between tax sheltering (which encompasses legal forms of reducing tax liability, like the aforementioned retirement plans) and "abusive" tax sheltering (i.e., tax evasion, which is illegal). One example of an abusive tax-sheltering scheme is the use of trusts to reduce tax liability by over-claiming deductions or even by hiding assets from taxation.

TAX HAVENS

The Internal Revenue Service makes a distinction between tax sheltering (which encompasses legal forms of reducing tax liability, like the aforementioned retirement plans) and "abusive" tax sheltering (i.e., tax evasion, which is illegal). One example of an abusive tax-sheltering scheme is the use of trusts to reduce tax liability by over-claiming deductions or even by hiding assets from taxation.

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Q. What did the 2008–10 Tax Stimulus Acts do?

A. The 2008 and 2009 tax acts provided large temporary tax cuts to most households, with the goal of helping the economy recover from the Great Recession. The 2010 tax act extended specific provisions of the 2009 act through 2012, along with most of the 2001 and 2003 income tax cuts. It also replaced the Making Work Pay credit with a 2 percentage point reduction in the 2011 payroll tax rate for workers.

ECONOMIC STIMULUS ACT OF 2008

The Economic Stimulus Act of 2008 had three main parts: an individual income tax rebate sent out in mid-2008 and two business provisions to encourage investment during 2008.

Tax Credits for Individuals

People who filed tax returns for either 2007 or 2008 could qualify for "recovery rebates." In total, the rebates lowered federal taxes by about 5 percent in 2008, reducing the estimated average effective federal tax rate from 19.6 percent to 18.6 percent and cutting federal revenue by nearly $120 billion in fiscal years 2008 and 2009.

Most tax filers received a basic credit of $600—or $1,200 for joint filers—up to their income tax liability before subtraction of child and earned income credits. Tax filers who qualified for less than $300 of the full basic credit ($600 for joint filers) could get $300 ($600 for joint filers) if they had either (1) at least $3,000 in earnings, Social Security benefits, and veteran's payments or (2) net income tax liability of at least $1 and gross income above specified thresholds.

Those thresholds equaled the sum of the applicable basic standard deduction plus one personal exemption (two personal exemptions for a joint return). That value was $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 qualified for a basic credit could also receive an extra $300 credit for each child eligible for the regular child credit. The sum of the basic and child credits was reduced by 5 percent of the tax filer's adjusted gross income over $75,000 ($150,000 for joint filers).

Background

What did the 2008–10 Tax Stimulus Acts do?

Investment Incentives for Businesses

Two provisions were designed to help businesses:

1. A one-year doubling of the limitation on expensing depreciable business assets (that is, deducting their full cost in the year the investment was made). This allowed firms to write off up to $250,000, reduced by the amount of qualifying investment over $800,000. After 2008 the limit reverted to $125,000 (indexed from 1997), reduced by the amount of qualifying investment over $500,000 (also indexed from 1997).
2. A "special depreciation allowance for certain property" allowed firms to claim an additional first-year depreciation of 50 percent of the cost of qualifying investments contracted for and placed in service during 2008 (in addition to the amount of investment they could expense).

The estimated cost of the two provisions over 10 years: $7.5 billion. Specifically, the Joint Committee on Taxation estimated that revenues would drop $51 billion in fiscal 2008 and 2009, offset by $43.5 billion of additional revenue in subsequent years because firms would be unable to depreciate previously expensed investments.

AMERICAN RECOVERY AND REINVESTMENT TAX ACT OF 2009

The American Recovery and Reinvestment Tax Act (ARRA) reduced federal taxes by an estimated $287 billion over 10 years. About 80 percent of the tax cuts—$232 billion—were for individuals; smaller cuts subsidized investment in renewable energy and a handful of provisions for businesses. The Urban-Brookings Tax Policy Center (2009a) evaluated each of the act's major provisions, grading them on how large and quick a boost they would give to the economy. Provisions that increased households' after-tax income quickly—and thus were most likely to increase spending quickly—received the highest grades. But no provision earned an A.

The "Making Work Pay" Tax Credit

Effective for 2009 and 2010, the Making Work Pay tax credit accounted for half of individual tax cuts. The credit equaled 6.2 percent of earned income up to a maximum of $400 ($800 per couple) and phased out at a rate of 2 percent of income over $75,000 ($150,000 for couples). As a result, individuals with earnings between about $6,450 and $75,000 (between about $12,900 and $150,000 for couples) could get the maximum credit. Those with incomes exceeding $95,000 ($190,000 for couples) received no credit (Urban-Brookings Tax Policy Center 2009h).

A nontax provision extended "economic recovery payments" to certain individuals who did not qualify for the Making Work Pay credit. Payments totaling an estimated $14.2 billion went to recipients of Social Security, supplemental security income, railroad retirement benefits, and veterans' disability compensation or pension benefits (Urban-Brookings Tax Policy Center 2009h).

The Alternative Minimum Tax Patch

A one-year extension of the alternative minimum tax (AMT) "patch" temporarily raised the AMT exemption. The cost: about $70 billion over 10 years. The patch saved affected taxpayers an estimated average of about $2,400. Under permanent AMT law, roughly 30 million taxpayers would have owed the additional levy (Urban-Brookings Tax Policy Center 2009d).

Background

What did the 2008–10 Tax Stimulus Acts do?

Other Individual Tax Provisions

Other major provisions in ARRA replaced the HOPE education credit with the more generous and more refundable American opportunity credit (at a 10-year cost of $14.8 billion), increased the refundability of the child credit ($13.9 billion), boosted the earned income tax credit (EITC—$4.7 billion), and temporarily suspended taxation of the first $2,400 of unemployment benefits ($4.7 billion). All gave taxpayers more money to spend and thus help boost the economy. Two other provisions—the automobile sales tax credit ($1.7 billion) and the homeownership tax credit ($6.6 billion)—subsidized the purchase of cars along with homes for first-time buyers, thus targeting benefits for two industries hit hard by the Great Recession (Urban-Brookings Tax Policy Center 2009b, c, e, f, g, i).

Business Tax Provisions

A broad range of provisions included incentives for the production of "clean" energy ($20 billion), funding to finance infrastructure development ($19.6 billion), tax benefits for business investment ($8 billion), and other economic recovery tools ($6.5 billion). The largest single provision extended tax incentives to produce electricity from renewable fuels for three years at an estimated cost of $13 billion. Among a variety of infrastructure development tools, school construction bonds ($10 billion), Build America bonds ($4.3 billion), and help for financial institutions ($3.2 billion) provided the most assistance. Special allowances for business investment in 2009 ($6 billion) and provisions related to net operating losses ($3.2 billion) gave additional assistance to firms.

TAX RELIEF UNEMPLOYMENT INSURANCE REAUTHORIZATION AND JOB CREATION ACT OF 2010

Faced with the scheduled sunset of all provisions of the 2001 and 2003 Bush tax cuts and the 2009 stimulus act (as well as a number of other tax laws), and unable to agree on permanent changes, Congress temporarily extended many provisions in the (unpunctuated) Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010. The law had diverse effects on the tax code:

- It extended all of the 2001 and 2003 individual income tax cuts for two years through 2012.
- It extended selected provisions of the 2009 act for two years through 2012, including
  - the higher EITC phaseout threshold for married couples filing jointly ($5,000 above that for single filers, indexed for inflation);
  - the 45 percent EITC phase-in rate for families with three or more children;
  - the $3,000 threshold (unindexed) for refundability of the child tax credit; and
  - the American Opportunity Tax Credit for higher education.
- It set an effective exemption of $5 million and a 35 percent tax rate for the estate tax for 2011 and 2012, and replaced the state death tax credit with a deduction.
- It reduced the Social Security (OASDI) tax rate on employees to 4.2 percent for 2011 and the self-employment tax rate by 2 percentage points for 2011. (However, the act did not reduce the amount of self-employment tax that taxpayers could deduct on their income tax returns.)
- It raised the AMT exemption to $47,450 for single filers and $72,450 for married couples filing jointly for 2010 and to $48,450 and $74,450, respectively, for 2011.
- It extended other expiring tax provisions, including the deduction for state and local general sales taxes, the above-the-line deduction for education expenses, and the educator expense deduction, through 2011.

Overview

What did the 2008–10 Tax Stimulus Acts do?

The temporary reduction in the Social Security tax effectively replaced the Making Work Pay (MWP) credit from the 2009 stimulus. That swap reduced the tax savings for low-income workers—single people with earnings under $20,000 and couples with earnings under $40,000—and provided large new tax breaks for high earners. Recall that single workers with income over $95,000 and couples with income over $190,000 got no MWP credit. In contrast, the cut in the Social Security tax rate saved high earners—those with earnings at or above the $106,800 cap on earnings subject to the tax in 2011—$2,136 in payroll taxes and double that for high-earning couples.

A Tax Policy Center analysis showed that, while about two-thirds of households in the lowest income quintile (income under about $18,000) would have gotten either credit, their average MWP credit would have been twice their payroll tax savings—$371 versus $178. Meanwhile, nearly 90 percent of households in the top quintile (income over about $105,000) got an average payroll tax cut of about $2,250, compared with just 60 percent who would have gotten MWP credits averaging about $650.

Background

What did the 2008–10 Tax Stimulus Acts do?

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Q. What did the American Taxpayer Relief Act of 2012 do?

A. The American Taxpayer Relief Act of 2012 made permanent most of the tax cuts enacted between 2001 and 2010 and extended other temporary tax provisions for between one and five years.

Numerous tax cuts enacted between 2001 and 2010 were scheduled to expire after 2012, part of the "fiscal cliff" that threatened to cut short nascent recovery from the Great Recession. The expirations involved four tax acts:[1]

- Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased in tax cuts for most taxpayers, but scheduled all of the cuts to expire after 2010 to avoid conflict with Senate rules (Joint Committee on Taxation 2001).
- Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the phase-in of some of EGTRRA's provisions, but retained their expiration dates (Joint Committee on Taxation 2003).
- American Recovery and Reinvestment Tax Act of 2009 (Division B, Title I of the American Recovery and Reinvestment Act, or ARRA) provided a number of temporary tax cuts designed to stimulate the economy, all of which were to sunset by the end of 2010 (Altshuler et al. 2009).
- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended most provisions of those three acts through 2012 (Urban-Brookings Tax Policy Center 2010).
- The Tax Policy Center's analysis of the scheduled expirations found that failure to extend them would have raised taxes by more than $500 billion in 2013—an average of almost $3,500 per household. Roughly 90 percent of Americans would have seen their tax bills rise (Williams et al. 2012).

Congress passed the American Taxpayer Relief Act of 2012 (ATRA) early on January 1, 2013, to prevent most of the sun-setting tax cuts from expiring. Most 2001 and 2003 income tax cuts were made permanent for all but the highest-income taxpayers. Three ARRA provisions were extended through 2017, while permanent changes to the estate tax and the alternative minimum tax reduced the number of people affected and indexed those provisions for inflation.

Background

What did the American Taxpayer Relief Act of 2012 do?

TAX PROVISIONS MADE PERMANENT

Income Tax Provisions

- *Tax Rates:* Maintains the basic marginal tax rate structure of 10, 15, 25, 28, 33, and 35 percent for taxable income under $400,000 ($450,000 for married taxpayers filing jointly); the thresholds are indexed for inflation after 2013. Taxpayers with taxable income above the thresholds face a 39.6 percent marginal tax rate.
- *Pease and PEP:* The limitation on itemized deductions (Pease) and the personal exemption phaseout (PEP) applies only to taxpayers with adjusted gross incomes of $250,000 or more ($300,000 for married taxpayers filing jointly); the thresholds are indexed for inflation after 2013.
- *Child Credits:* The child tax credit (CTC) equals $1,000 per child and is refundable up to 15 percent of earnings above $10,000 (indexed for inflation after 2001). Another ATRA provision temporarily reduced the refundability threshold to $3,000. The child and dependent tax care credit rate begins at 35 percent on eligible expenses up to $3,000 per child (to a maximum of $6,000) and phases down to 20 percent between AGIs of $15,000 and $43,000.
- *Marriage Penalty:* The standard deduction and the 10 percent and 15 percent brackets for joint filers equal twice those for single filers.[2]
- *Education Tax:* Maintains higher annual contribution limits for Coverdell education savings accounts and higher phaseout ranges for the student loan interest deduction.
- *Capital Gains and Dividends:* Retains 15 percent tax rates on long-term capital gains and qualified dividends (0 percent for those who would otherwise be in the bottom two tax brackets) for taxpayers in all but the top income tax bracket; sets a 20 percent rate for those in the top bracket.
- *Alternative Minimum Tax (AMT):* Sets the 2012 AMT exemption at $50,600 ($78,750 for married taxpayers filing jointly) and indexes the exemption amount, the exemption phaseout threshold, and the future tax brackets for inflation.

Estate and Gift Taxes

ATRA sets a $5 million effective estate and gift tax exemption (indexed for inflation from 2011) and a top estate tax rate of 40 percent. A surviving spouse may claim any exemption not previously used by the deceased, a feature termed "portability."

EXTENSION OF TEMPORARY TAX PROVISIONS

Tax Extenders

Congress regularly renews a few dozen temporary tax provisions, known as extenders, for one or two years at a time. ATRA extended that group of tax provisions through 2013. Most extenders had expired at the beginning of 2012; their ATRA extensions were retroactive, making them effective for 2012.

Background

What did the American Taxpayer Relief Act of 2012 do?

Extension through 2017 of Certain 2009 Tax Cuts

- The American opportunity tax credit, which replaced the HOPE education credit in 2009.
- The CTC is refundable up to 15 percent of earnings above $3,000 (not indexed for inflation), which is reduced from earnings above $10,000 (indexed for inflation from 2001).
- The earned income tax credit threshold for couples filing jointly is set at $5,000 (indexed from 2008) above the phaseout for single filers. The phase-in rate for families with three or more children is raised to 45 percent.

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[1] Another tax law, the Temporary Payroll Tax Cut Continuation Act of 2011, extended through 2012 a cut in employees' share of the payroll tax funding Social Security, from 6.2 percent to 4.2 percent. ATRA did not extend that provision.

[2] ATRA also temporarily extended the higher earned income tax credit phaseout threshold for joint filers.

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Key Elements of the U.S. Tax System

What's the difference between tax deductions and tax credits?

Q. What's the difference between a tax deduction and a tax credit?

A. Deductions reduce taxable income and their value thus depends on the taxpayer's marginal tax rate, which rises with income. Credits reduce taxes directly and do not depend on tax rates. However, the value of credits may depend on the taxpayer's basic tax liability. Non-refundable credits can reduce tax to zero but any credit beyond that is lost.

OVERVIEW

An individual tax filer has the choice of claiming the standard deduction or itemizing deductible expenses from a list that includes 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 brackets. For example, a $10,000 deduction reduces taxes by $1,500 for people in the 15 percent tax bracket, whereas the same deduction cuts taxes by $3,500 for those in the 35 percent tax bracket.

IMPACT OF DEDUCTIONS

Determining the actual tax savings associated with deductions is, however, somewhat more complicated. High-income taxpayers have their itemized deductions reduced by the limitation on itemized deductions, called "Pease" after the Ohio congressman who proposed the provision. In 2017, Pease reduces itemized deductions by 3 percent of the amount by which adjusted gross income exceeds specified thresholds—$261,500 for single filers, $287,650 for heads of household, $313,800 for married couples filing jointly, and half of that for married couples filing separately. The limitation cannot reduce deductions by more than 80 percent, however.

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.

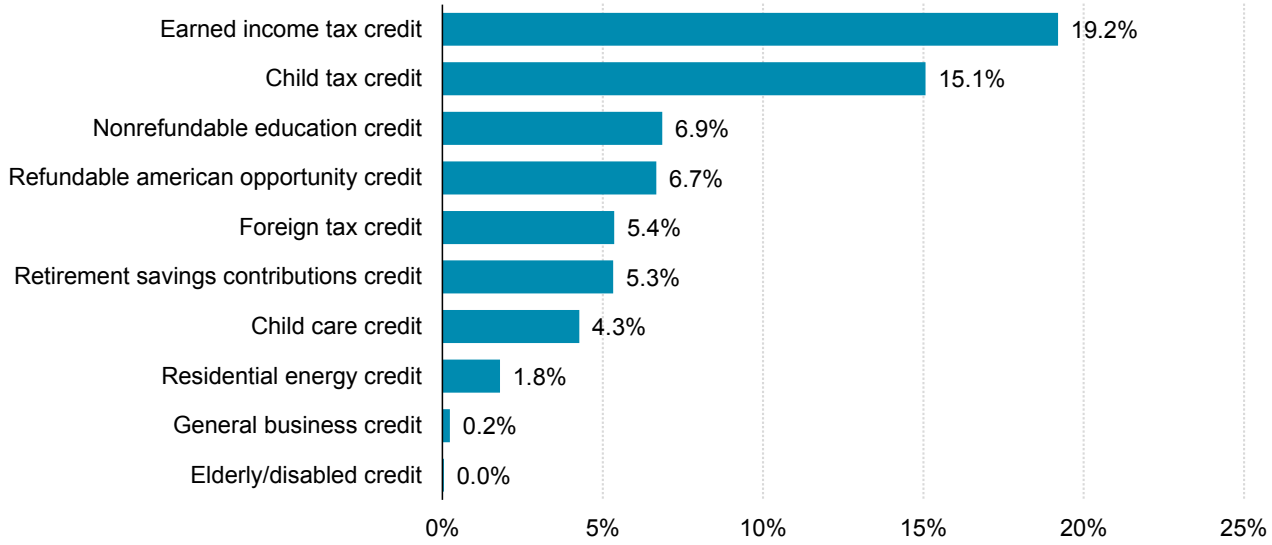
Key Elements of the U.S. Tax System

What's the difference between tax deductions and tax credits?

FIGURE 1

Percentage of All Returns Claiming Selected Credits

2014

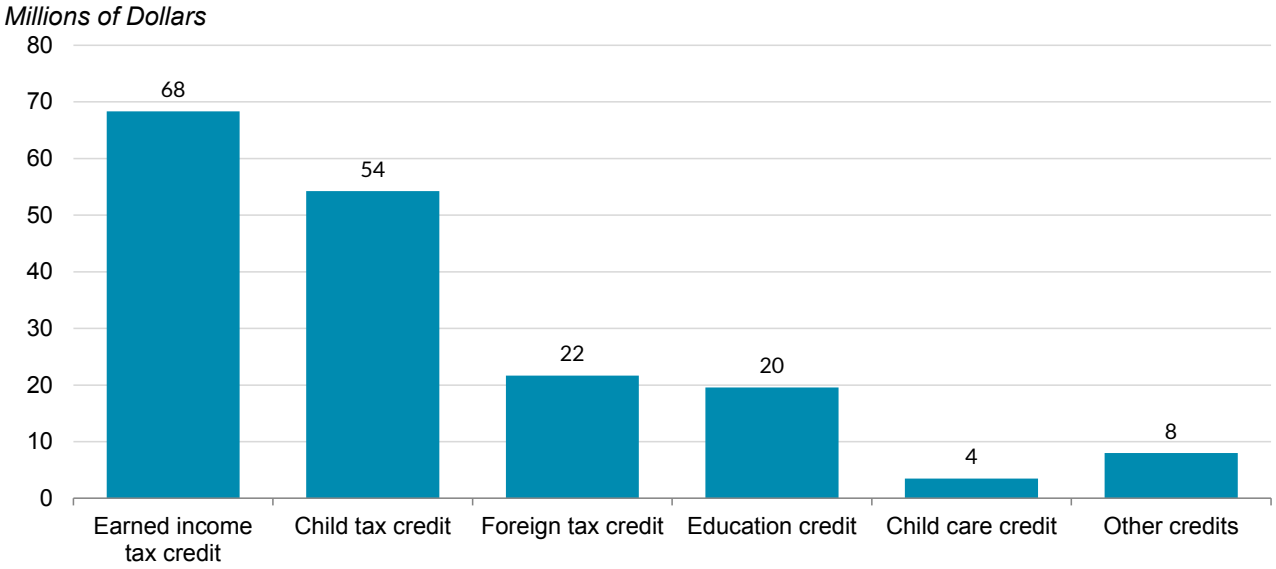


Source: Internal Revenue Service, Statistics of Income, Table A.
Note: .04% of all returns claim elderly/disabled credit.

FIGURE 2

Total Tax Credits by Type

2014



Source: Internal Revenue Service, Statistics of Income, Table A.

Key Elements of the U.S. Tax System

What's the difference between tax deductions and tax credits?

Tax filers may claim some deductions in addition to the standard deduction or itemized deductions. These include deductions for contributions to individual retirement accounts, alimony payments, certain moving expenses, and interest on student loans. The personal exemption ($4,050 each for taxpayers and their dependents in 2017) 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.

IMPACT OF CREDITS

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

NONREFUNDABLE CREDITS

Most tax credits are nonrefundable; that is, they cannot reduce a filer's tax liability below zero. As a result, low-income filers often cannot receive the full benefit of the credits for which they qualify. For example, the child and dependent care credit is nonrefundable, so a married couple with two children and income under $28,900 in 2017 cannot receive the credit because the family has no income tax liability.

REFUNDABLE CREDITS

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 if the filer's earnings exceed a $3,000 threshold.

MOST POPULAR CREDITS

The EITC is the most commonly claimed credit, showing up on about 19 percent of 2014 tax returns. The CTC was nearly as popular, claimed on more than 15 percent of 2014 tax returns (figure 1).

The EITC is also the most costly tax credit, totaling about $68 billion in 2014. The child credit was the second largest at roughly $54 billion (figure 2).

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Q. How do phaseouts of tax provisions affect taxpayers?

A. Many preferences in the tax code phase out for high-income taxpayers—their value falls as income rises. Phaseouts narrow the focus of tax benefits to low- and middle-income households while limiting revenue costs, but raise marginal tax rates for affected taxpayers.

Many preferences in the tax code are phased out (meaning 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, however, not only claw back these benefits from the more affluent, they also increase the effective marginal tax rate these taxpayers face, decreasing the after-tax gains of earning more income.

Some taxpayers are affected by multiple tax provisions phasing out at the same time, compounding the negative impact on their earning incentives. More broadly, phaseouts complicate the tax code and make it more difficult for taxpayers to understand the taxes they pay.

HOW DO PHASEOUTS WORK?

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

Phaseouts reduce tax benefits at different rates depending on their structure and range (table 1). Most phaseouts reduce benefits at a constant rate over an income range; that rate depends on the width of the range. For example, for single tax filers, the American Opportunity Tax Credit phases out evenly 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 specified amount for each fixed increment of income. For example, the child tax 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, so earning a few more dollars could make a taxpayer worse off.

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

TABLE 1

SELECTED PHASE-INS AND PHASEOUTS IN THE 2017 INDIVIDUAL INCOME TAX CODE

Provision	Description	Effect on marginal tax rate	Filing status	Phaseout begins/ends	
EXEMPTIONS AND DEDUCTIONS					
Personal exemption	Exemption of $4,050 per taxpayer or dependent is reduced 2% for each $2,500 (or part thereof) of AGI above threshold.	Effect depends on total exemptions and taxpayers statutory tax rate.	Single	$261,500*	$384,000*
			HoH	$287,650*	$410,150*
			MFJ	$313,800*	$436,300*
			MFS	$156,900*	$218,150*
Itemized deduction	Itemized deductions reduced 3% of AGI above threshold, up to 80% of deductions.	Increases by 3% of statutory tax rate.	Single	$261,500*	N/A
			HoH	$287,650*	N/A
			MFJ	$313,800*	N/A
			MFS	$156,900*	N/A
WORK PROVISIONS					
Earned Income Tax Credit	Credit phases in from first dollar of earnings; phaseout threshold based on marital status and number of children. Phase-in and phaseout rates vary with number of children: none - 7.65%, 7.65%; one - 35%, 15.98%; two - 40%, 21.06%, three or more - 45%, 21.06%.	Decreases by credit percentage during phase-in.	Single/HOH		
			No children	$8,340*	$15,010*
			One child	$18,340*	$39,617*
			Two children	$18,340*	$45,007*
			3+ children	$18,340*	$48,340*
		Increases at phaseout	MFJ		
			No children	$13,930*	$20,600*
			One child	$23,930*	$45,207*
			Two children	$23,930*	$50,597*
			3+ children	$23,930*	$53,930*
			MFS	Credit not allowed	
CHILD PROVISIONS					
Child Tax Credit	Credit of $1,000 per child is reduced by $50 for each $1,000 or part thereof above start of phaseout.	Increases by 5 percentage points throughout phaseout range.	Single/HoH	$75,000	N/A
			MFJ	$110,000	N/A
			MFS	$55,000	N/A
Child and Dependent Care Credit	Credit of up to $3,000 for each of up to two children; credit rate falls from 35% to 20% at rate of 1% for each $2,000 of income above threshold.	Increases by up to 3 percentage points, depending on number of children and spending on child care.	Single/HoH	$15,000	$43,000
			MFJ	$15,000	$43,000
			MFS	Credit not allowed	
Adoption Credit	Credit of up to $13,570 (regardless of the number of children adopted) is reduced evenly over phaseout range.	Increases by up to 32.9 percentage points, depending on expense.	All	$203,540*	$243,540*

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

EDUCATION PROVISIONS					
American Opportunity Credit	Credit of 100% of first $2,000 and 25% of next $2,000 of eligible expenses.	Increases by up to 25 percentage points (12.5 for MFJ) per student, depending on expenses.	Single/HoH	$80,000*	$90,000*
			MFJ	$160,000*	$180,000*
			MFS	Credit not allowed	
Lifetime Learning Credit	Credit of 20% of eligible expenses up to $10,000.	Increases by up to 20 percentage points (10 for MFJ), depending on expenses.	Single/HoH	$56,000*	$65,000*
			MFJ	$112,000*	$130,000*
			MFS	Credit not allowed	
Education tuition and fees deduction	Maximum deduction of $4,000 below lower threshold; $2,000 between thresholds; zero above upper threshold.	Large discrete increases at each threshold income value.	Single/HoH	$65,000	$80,000
			MFJ	$130,000	$160,000
			MFS	Deduction not allowed	
Coverdell Educational Savings Accounts	Maximum contribution of $2,000 is reduced evenly over phaseout range.	No effect on current tax rate, but increases tax rate when funds are withdrawn if distributions are not used for educational purposes or exceed qualified expenses for that year.	Single/HoH	$95,000	$110,000
			MFJ	$190,000	$220,000
			MFS	$95,000	$110,000
Student loan interest deduction	Up to $2,500 of qualifying student loan interest is deductable.	Increases by up to 16.7 percent (8.3 for MFJ) of statutory tax rate.	Single/HoH	$65,000*	$80,000*
			MFJ	$135,000*	$165,000*
			MFS	Deduction not allowed	
Education Savings Bond Program	Interest on qualified savings bonds is tax-free if used for higher education.	Depends on amount of interest on redeemed bonds and statutory tax rate.	Single/HoH	$77,200*	$92,200*
			MFJ	$115,750*	$145,750*
			MFS	$77,200*	$92,200*
RETIREMENT SAVINGS PROVISIONS					
Saver's Credit	Credit of up to $2,000 per taxpayer; credit rate falls in steps from 50% to 0%.	No effect on current tax rate but increases tax rate when funds are withdrawn.	Single/MFS	$18,5000*	$31,000*
			MFJ	$37,000*	$62,000*
			HoH	$27,750*	$46,500*
Roth IRA contribution limits	Maximum $5,500 all IRAs.	No effect on current tax rate but increases tax rate when funds are withdrawn.	Single/HoH	$118,000*	$133,000*
			MFJ	$186,000*	$196,000*
			MFS	$0	$10,000
			(if lived together at all)		
Traditional IRA contribution limits (own)	Maximum $5,500 all IRAs.	Increases by up to 25% of statutory tax rate.	Single/HoH	$62,000*	$72,000*
			MFJ	$99,000*	$119,000*
			MFS	$0	$10,000
Deductible IRA contribution limits (spouse)	Maximum $5,500 all IRAs.	Increases by up to 25% of statutory tax rate.	MFJ	$186,000*	$196,000*
			MFS	$0	$10,000
Taxation of Social Security benefits	Up to 85% of Social Security benefits included in taxable income (50% during phase-in range and 85% beyond it).	Increases by 50% of statutory tax during phase-in; increases by 85% of statutory tax rate above phase-in (subject to income).	Single/HoH	$25,000	$34,000
			MFJ	$32,000	$44,000
			MFS	$0	$0
			(if lived together at all)		

ALTERNATIVE MINIMUM TAX					
AMT exemption	Exemption reduced by 25 percent of income above phase-out threshold.	Increases by 25% of AMT tax rate if liable for AMT.	Single/HoH	$120,700	N/A
			MFJ	$160,900	N/A
			MFS	$80,450	N/A

Source: Tax Policy Center, 2016. Based on various Internal Revenue Service publications and individual income tax forms.
Notes: AGI = adjusted gross income; HoH = head of household; MFJ = married filing jointly; MFS = married filing separately; N/A = not applicable.
* Indexed for inflation.

Some phaseouts have more pronounced cliffs, so the benefit drops in large increments when income exceeds the threshold. For example, in 201, the limit on the deduction for higher education tuition and fees drops from $4,000 to $2,000 for a single tax filer if income exceeds $65,000 by even $1, and then drops to zero when income tops $80,000. Again, just a few dollars of additional income could leave a taxpayer whose income is near the cliff much worse off.

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.

HOW PHASEOUTS CREATE MARRIAGE PENALTIES AND BONUSES

Many phaseouts create significant marriage penalties—or bonuses—because the phaseout range for married couples is less than twice that for single tax filers. For example, in 2017 the phaseout of personal exemptions begins at $313,800 for married couples filing jointly, less than twice the $261, 500 threshold for single filers. Consider a couple in which each spouse has income of $200,000. The phaseout would not affect either spouse if they were not married—each would have income under the single threshold—but as joint filers they lose 70 percent of their combined $8,100 personal exemptions, increasing their taxable income by nearly $5,700.

Phaseouts can also create marriage bonuses, reducing a couple's combined tax bill. For example, if one spouse has $300,000 of income and the other spouse has none, their combined income would be under the $313,800 threshold for reducing exemptions for joint filers in 2017. If they were single, the high-earning spouse would lose 32 percent of her personal exemption, which would increase her taxable income by nearly $1,300.[1]

Phaseouts also impose marriage penalties on low-income families, and those penalties are often a larger percentage of their income than the marriage penalties caused by phaseouts for higher-income taxpayers.

In 2016, a single mother who earns $17,450 and has one child pays no income tax and receives two refundable credits—a $1,000 child tax credit (CTC) and a $3,373 earned income tax credit (EITC) (table 2).[2] If she marries a man making $40,000—whose 2016 income tax as a single person would be $3,984—she would lose all of her EITC (the couple's income would cause the credit to phase out completely) but would retain her CTC. Losing the EITC means that the couple would pay $2,978 in income tax when married, compared with receiving a net payment of $354 (her $4,349 combined credit minus his $3,995 tax) if they remained single. That difference is a marriage penalty of $3,332, or 5.8 percent of the couple's adjusted gross income.

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

TABLE 2

Marriage Bonus and Penalty Tax Calculator Example

$2016

	Mother	Spouse	Couple
Adjusted gross income	**$17,450**	**$40,000**	**$57,450**
Personal exemptions	$8,000	$4,050	$12,150
Standard deduction	$9,300	$6,300	$12,600
Taxable income	**$50**	**$29,650**	**$32,700**
Tax before credits	$5	$3,984	$3,978
Child Tax Credit	$1,000	$0	$1,000
Earned Income Tax Credit	$3,373	$0	$0
Tax Net of Credits	**-$4,368**	**$3,984**	**$2,978**

Tax as two individuals
-$384
Tax as a married couple
$2,978
Marriage penalty
$3,362
Difference as a percent of couple's AGI
5.9%

Source: Tax Policy Center Marriage Bonus and Penalty Calculator, 2015.

[1] The married couple's bonus would be even larger because, having no income, the nonearner could not benefit from the personal exemption. Filing jointly, the couple would get the full value of both spouses' exemptions.

[2] In 2016, a single mother with one child begins paying income tax (before credits) when her income exceeds $17,450—the sum of her $9,350 standard deduction for a head of household and personal exemptions for herself and her child totaling $8,100.

Data Sources

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———. Individual Retirement Arrangements (IRAs), Publication 590.

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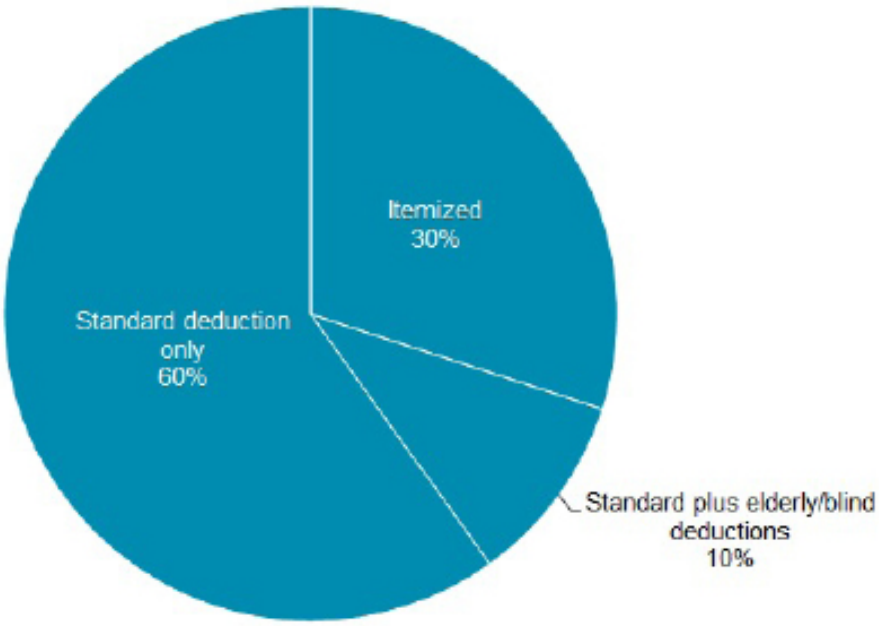
Q. How do the standard and itemized deductions compare?

A. Both reduce taxable income by the amount of the allowed deduction; the tax savings depend on the taxpayer's bracket. About two-thirds of taxpayers claim the standard deduction (figure 1).

FIGURE 1

Two-Thirds of Taxpayers Take the Standard Deduction

Returns by type of deduction, 2014



Source: Internal Revenue Service, Table A.

Tax filers may choose to take the standard deduction or to itemize the actual amounts spent on allowed deductible expenses. The most common itemized deductions are state and local taxes, mortgage interest, charitable contributions, medical and dental expenses, and casualty and theft losses.

Key Elements of the U.S. Tax System

How do the standard and itemized deductions compare?

Most taxpayers choose the standard deduction because it is larger than the deductions they can itemize. Others choose that option because it's easier than identifying and totaling the expenses they could itemize or because they do not realize that itemizing would reduce their tax liability.

In a 2002 study, the Congressional Research Service (CRS) estimated that roughly 950,000 tax filers would have saved more than $470 million on their 1998 tax returns if they had itemized mortgage interest and state and local income taxes instead of claiming the standard deduction. Adding charitable contributions and other taxes to the mix, the CRS found that some 2.2 million taxpayers could have saved nearly $1 billion by itemizing.

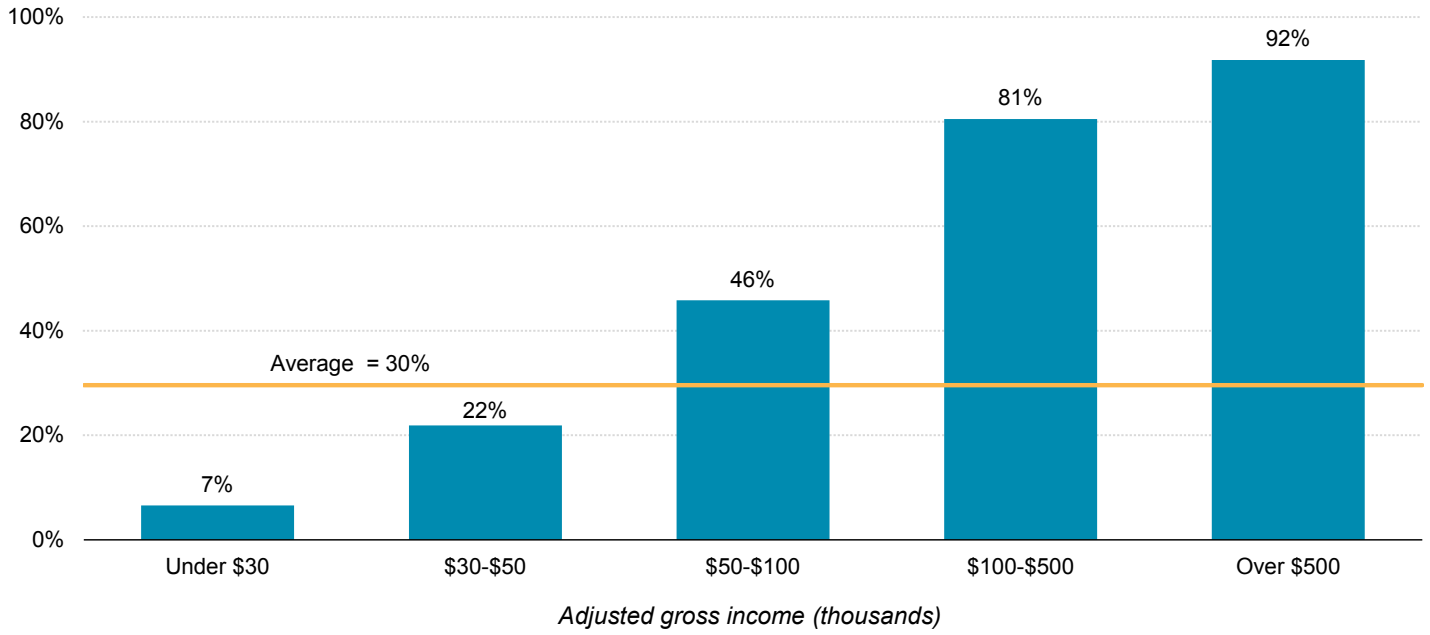
WHO ITEMIZES AND HOW MUCH DO THEY CLAIM?

High-income taxpayers are much more likely to itemize. In 2014, more than 90 percent of tax returns reporting adjusted gross income (AGI) over $500,000 itemized deductions, compared with just under half of those with AGI between $50,000 and $100,000 and less than 10 percent of those with AGI under $30,000 (figure 2).

FIGURE 2

High Income Tax Filers Were More Likely to Itemize Deductions in 2014

Share of tax units claiming itemized deductions



Source: Internal Revenue Service, Table 1.2.

Key Elements of the U.S. Tax System

How do the standard and itemized deductions compare?

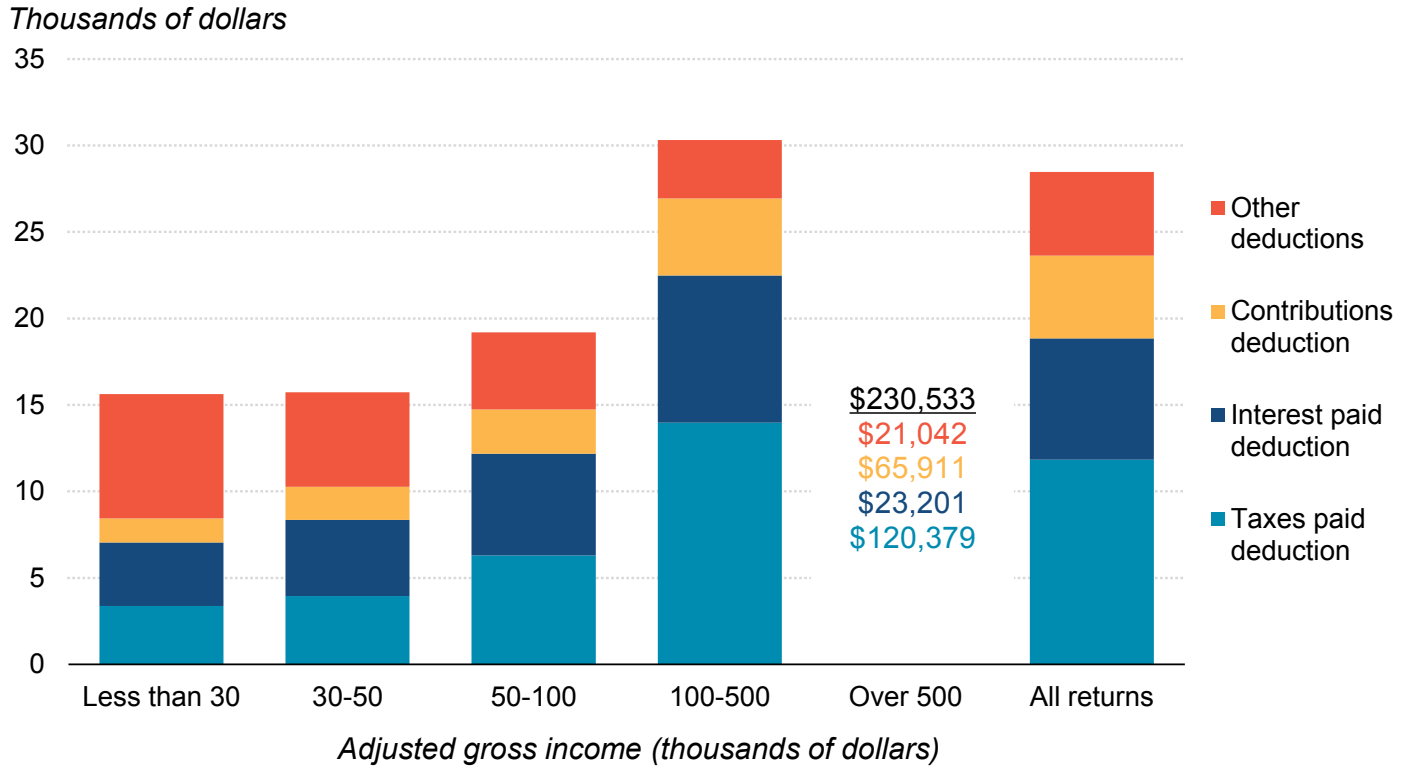
The limitation on itemized deductions (sometimes called "Pease" after the Ohio congressman who proposed it) reduces deductions for high-income taxpayers by 3 percent of the amount by which their AGI exceeds a threshold—$261,500 in 2017 ($287,650 for heads of household, $313,800 for married couples filing jointly, and half of that for married couples filing separately)—but not by more than 80 percent of deductions claimed. The 2001 tax act phased out the limitation and it disappeared entirely from 2010 through 2012 before the American Taxpayer Relief Act of 2012 restored it in its current form.

HOW MUCH AND WHAT EXPENSES DO ITEMIZERS DEDUCT?

Itemized deductions averaged about $27,400 in 2014 for the 44 million tax units claiming them. The amount claimed rises with income, from just under $16,000 for taxpayers with AGI under $50,000 to about $30,000 for those with AGI between $100,000 and $500,000 and more than $230,000 for those with AGI over $500,000 (figure 3).

FIGURE 3

Average Itemized Deductions by Type and AGI
2014



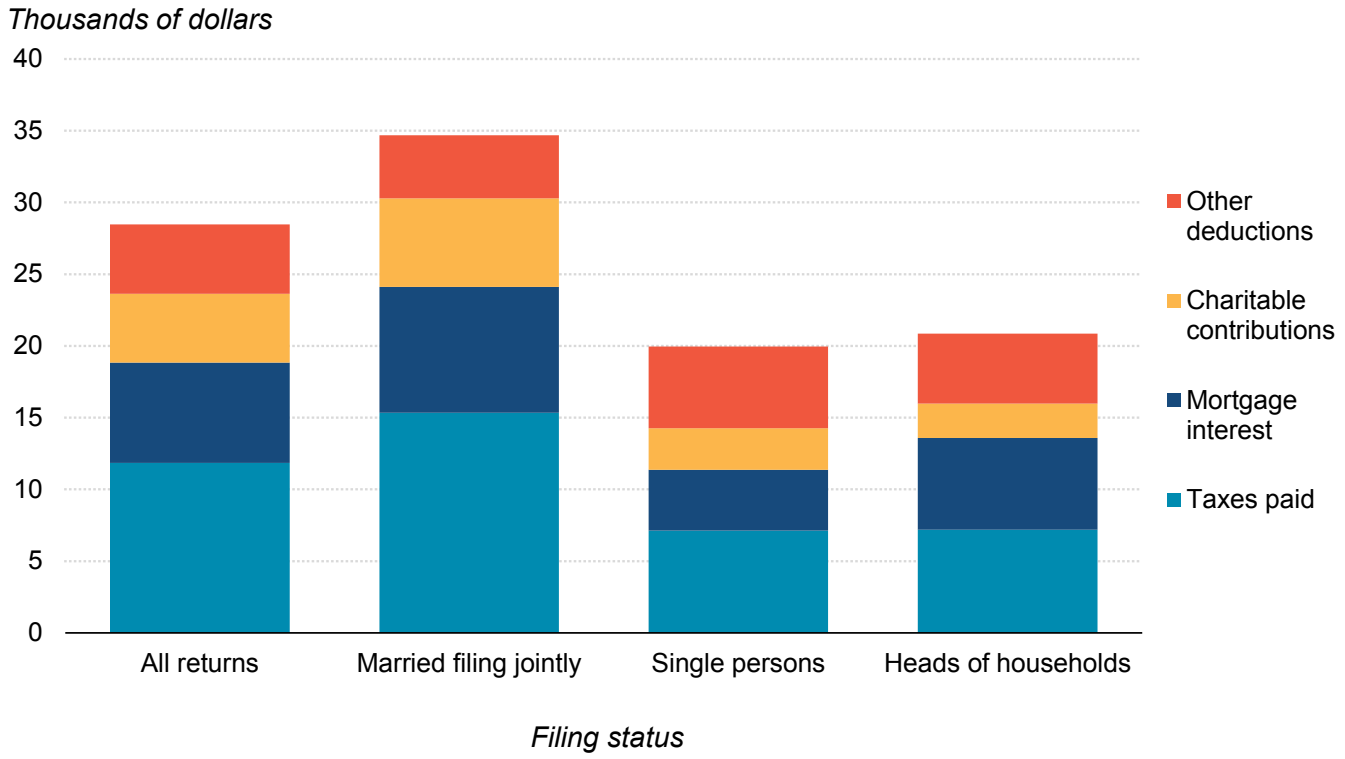
Source: Internal Revenue Service, Table 2.1

How do the standard and itemized deductions compare?

State and local taxes accounted for over 40 percent of average itemized deductions in 2014, or about $11,800. The mortgage and other interest deductions made up another 25 percent, averaging about $7,000. Charitable contribution and miscellaneous deductions averaged about $4,800 each, or about 17 percent of total itemized deductions (figure 3).

FIGURE 4

Itemized Deductions by Type and Filing Status
2014



Source: Internal Revenue Service, Table 1.3.

Married couples filing jointly typically claim higher deductions, averaging more than $39,000 in 2014. Itemized deductions averaged over $25,000 for single filers and about $26,000 for heads of households. The differences across filing status reflect both the higher standard deduction for joint filers—their itemized deductions must be higher to make itemizing the better choice—and the higher average income of couples relative to unmarried tax filers.

Key Elements of the U.S. Tax System

How do standard and itemized deductions compare?

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Q. How are capital gains taxed?

A. Capital gains are profits from the sale of a capital asset, such as shares of stock, a business, a parcel of land, or a work of art. Capital gains are generally included in taxable income, but in most cases are taxed at a lower rate.

A capital gain is realized when a capital asset is sold or exchanged at a price higher than its basis. Basis is an asset's purchase price, plus commissions and the cost of improvements, minus 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, not adjusted for inflation.

Capital gains and losses are classified as long term if the asset was held for more than 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 long-term gains on most assets; taxpayers in the 25-, 28-, 33-, or 35-percent income tax brackets face a 15 percent rate on long-term capital gains. For those in the top 39.6 percent bracket for ordinary income, the rate is 20 percent. Short-term capital gains are taxed at the same rate as ordinary income. There also is a 3.8 percent tax on net investment income for single taxpayers with modified adjusted gross income above $200,000 ($250,000 for married couples filing jointly). Note, too, that capital gains in some cases face an effective tax rates above the 23.8 percent statutory rate because of phaseouts in the tax code.

Gains on art and collectibles are taxed as ordinary income up to a maximum 28 percent rate. Taxpayers may realize up to $250,000 of gains on their principal residences tax free (or up to $500,000 for married taxpayers filing jointly). 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.
Capital losses may be used to offset capital gains, along with up to $3,000 of other taxable income. The unused portion of a capital loss may be carried over to future years.

The tax 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 any gains on assets held until death from income tax.

C corporations pay the regular corporation tax rates on the full amount of their capital gains and may use capital losses only to offset capital gains, not other kinds of income.

Key Elements of the U.S. Tax System

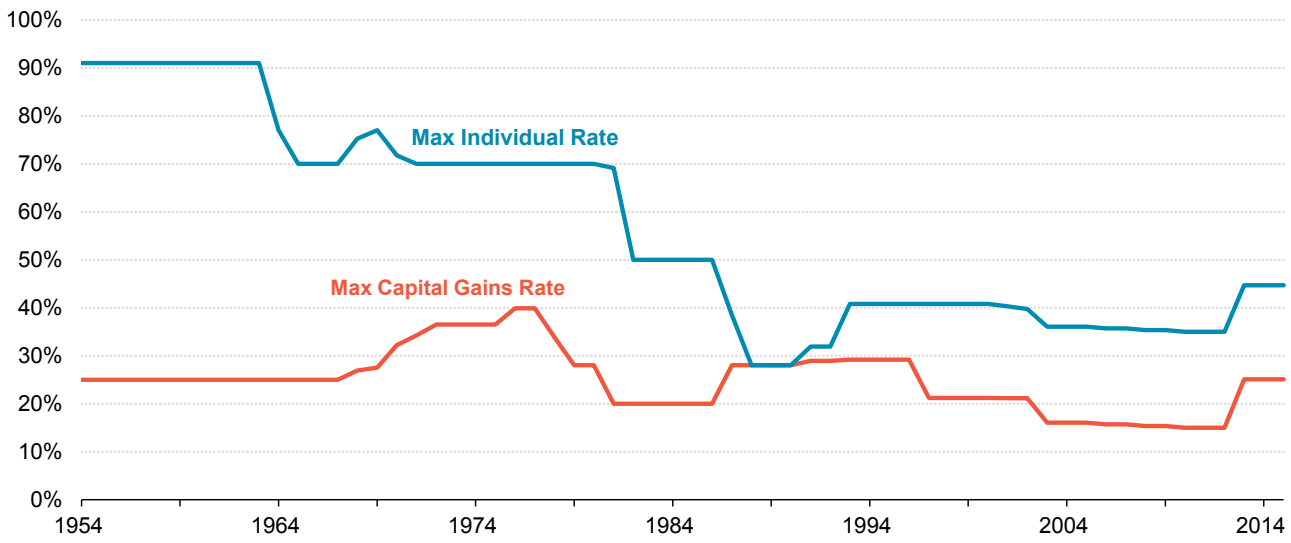
How are capital gains taxed?

For most of the history of the income tax, long-term capital gains have been taxed at lower rates than ordinary income. Since 2003, qualified dividends have also been taxed at the lower rates. Figure 1 below shows how the maximum long-term capital gains tax rate and the maximum ordinary individual income tax rate has changed over the years.

FIGURE 1

Maximum Capital Gains and Individual Tax Rate

1954–2015



Sources: Department of Treasury, Office of Tax Analysis. 2015; Tax Policy Center.
Note: The maximum rate includes the 3.8 percent tax on net investment income (2013-2015) and adjusts for the phaseout of itemized deductions (1991-2009, 2013-2015).

Data Sources

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Kobes, Deborah, and Leonard E. Burman. 2004. "Preferential Capital Gains Tax Rates." *Tax Notes*, January 19.

Q. What is the effect of a lower tax rate for capital gains?

A. It does not appear to spur economic growth significantly. But lower rates certainly do foster tax avoidance strategies and complexity.

Throughout the history of the income tax, capital gains have been taxed at lower rates than ordinary income. Since 2003, qualified dividends have also been taxed at the lower rates. Defenders of the tax preference argue that lower tax rates for capital gains and dividends offset the taxes that have already been paid at the corporate level. Some also claim that lower tax rates for capital gains spur growth, encourage risk-taking and entrepreneurship, offset the effects of inflation, and prevent "lock-in" (the disincentive to sell assets). Critics, for their part, complain that the lower tax rate disproportionately benefits the wealthy and encourages tax sheltering schemes.

The double taxation argument goes only so far. Capital gains from the sale of stock is only about half of all capital gains. And even when a gain arises from the sale of corporate stock, profits have not always been taxed at the corporate level because corporations use various tax preferences, too.

Do lower taxes on capital gains spur economic growth? Figure 1 shows the top tax rates on long-term capital gains along with real economic growth from 1950 to 2015. Of course, many factors determine growth, but the tax rate on capital gains does not appear to be significant.

Capital gains may arise from risky investments, and a lower capital gains tax rate presumably encourages such risk taking. However, taxing gains while allowing deductions for losses on a symmetric basis reduces risk by reducing the after-tax variance of returns. Under current law, taxpayers can use capital losses to offset capital gains and, for noncorporate taxpayers, up to $3,000 of additional taxable income other than capital gains. Noncorporate taxpayers also can carry any remaining capital losses forward to future years indefinitely.

It is true that part of almost any nominal capital gain is due 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, which are taxed upon disposition.

Meanwhile, the critics are correct that low tax rates on capital gains and dividends accrue disproportionately to the wealthy. The Tax Policy Center estimates that in 2016, three-quarters of the tax benefit of the lower rates were received by taxpayers with incomes over $1 million (table 1).

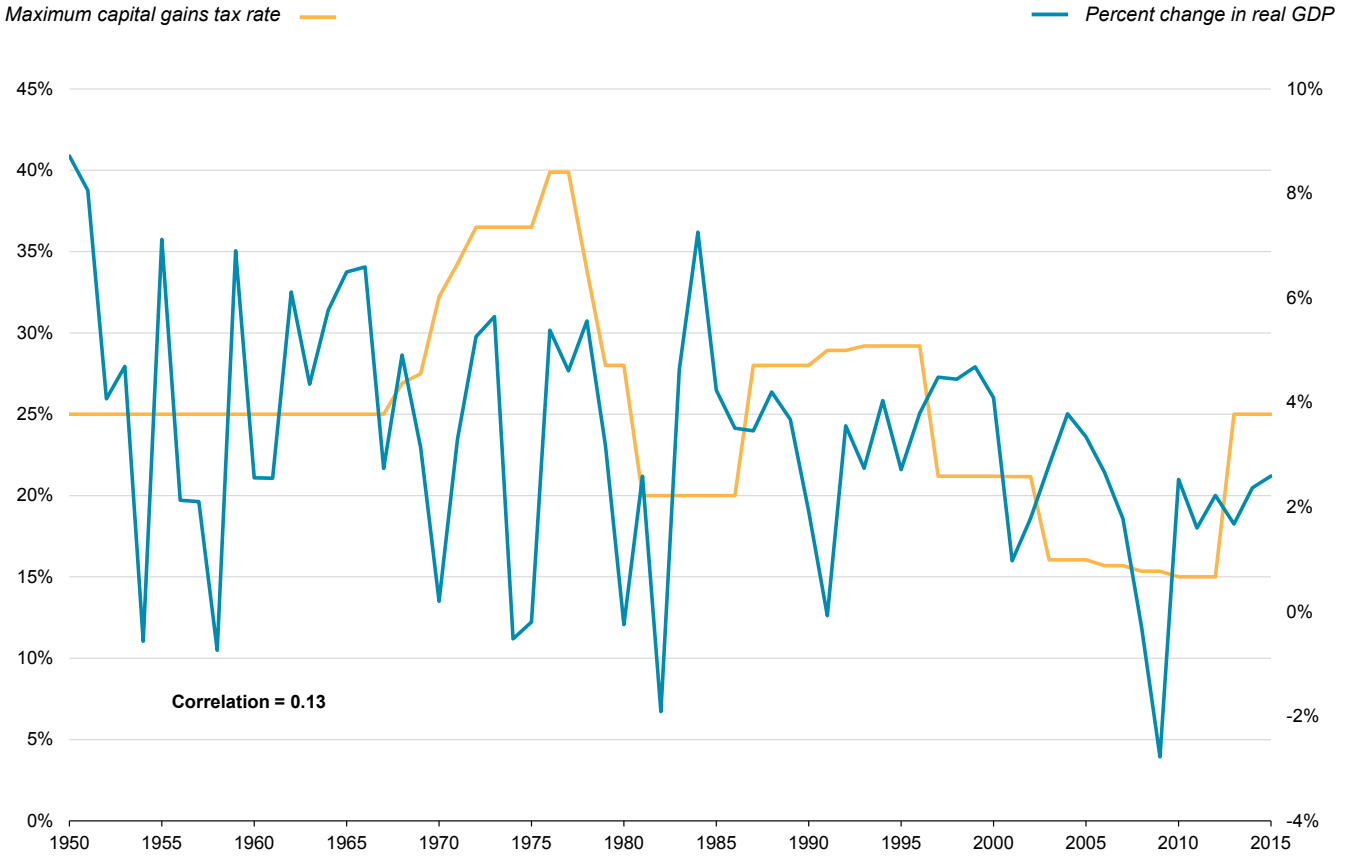
Key Elements of the U.S. Tax System

What is the effect of a lower tax rate for capital gains?

FIGURE 1

Top Capital Gains Tax Rates and Economic Growth

1950–2015



Sources: Citizens for Tax Justice; Bureau of Economic Analysis; Department of the Treasury, Office of Tax Analysis; Tax Policy Center calculations.

Low tax rates on capital gains also play a role in many tax shelters that undermine economic efficiency and growth. These shelters 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. The resources that go into designing, implementing, and managing tax shelters could be used for productive purposes.

Finally, the low rate on capital gains greatly complicates the tax system. A significant portion of tax law and regulations is devoted to policing the boundary between returns on capital assets and ordinary income.

Key Elements of the U.S. Tax System

What is the effect of a lower tax rate for capital gains?

TABLE 1

Benefit of Lower Tax Rates on Long-term Capital Gains

Current law, 2016

Cash income level	Share of returns with benefit	Benefit as share of after-tax income	Share of total federal tax change	Average tax savings
Less than $10,000	0.0%	0%	0%	$0
$10,000–$20,000	0.6%	0%	0%	*
$20,000–$30,000	1.6%	0%	0.1%	$10
$30,000–$40,000	3.2%	0%	0.2%	$10
$40,000–$50,000	5.5%	0.1%	0.3%	$30
$50,000–$75,000	10.4%	0.1%	1.4%	$70
$75,000–$100,000	18.6%	0.2%	2.2%	$170
$100,00–$200,000	26.8%	0.3%	6.8%	$300
$200,000–$500,000	48.6%	0.4%	6.7%	$830
$500,000–$1,000,000	77.5%	1.4%	6.6%	$6,830
More than $1,000,000	88.7%	6.9%	75.7%	$146,050
All	**12.6%**	**1.1%**	**100%**	**$740**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Note: * Non-zero value rounded to zero.

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Q. How might the taxation of capital gains be improved?

A. Taxing capital gains at the same rates as ordinary income would simplify the tax system by removing major incentives for tax sheltering and other attempts to manipulate the system.

The Tax Reform Act of 1986, signed by President Ronald Reagan, raised tax rates on capital gains and lowered rates on ordinary income, but set the same 28 percent top rate for both. The goal: reducing tax planning devoted to converting ordinary income to capital gains. The policy worked—briefly. Successive congresses raised the top rate on ordinary income (now 43.4 percent) and reduced the top rate on capital gains (now 23.8 percent). As the gap between the two rates widened, so did the incentives to manipulate the system. Now might be a good time to once again tax capital gains and ordinary income at the same rate, which would be higher than today's rate on capital gains but lower than the rate on ordinary income.

In the 1980s, taxpayers exploited the ordinary income/capital gain gap by making investments that generated ordinary deductions—such as interest, lease payments and depreciation—to reduce their current income tax liability. These taxpayers got their money back (and presumably more) in the form of long-term capital gains. The '86 act targeted these arrangements by limiting the use of passive loss, interest, and accelerated depreciation deductions. But, most importantly, the '86 act also eliminated the ordinary income/capital gain gap, which removed much of the juice.

With the return of the ordinary income/capital gap, various schemes to convert ordinary income into capital gains have followed. Last year, the Senate investigated basket options, which used the tax alchemy of derivatives to convert short-term into long-term capital gains. Over the last several years, private equity and other investment managers have been compensated with "carried interest," which allow them to claim long-term gains rather than salaries.

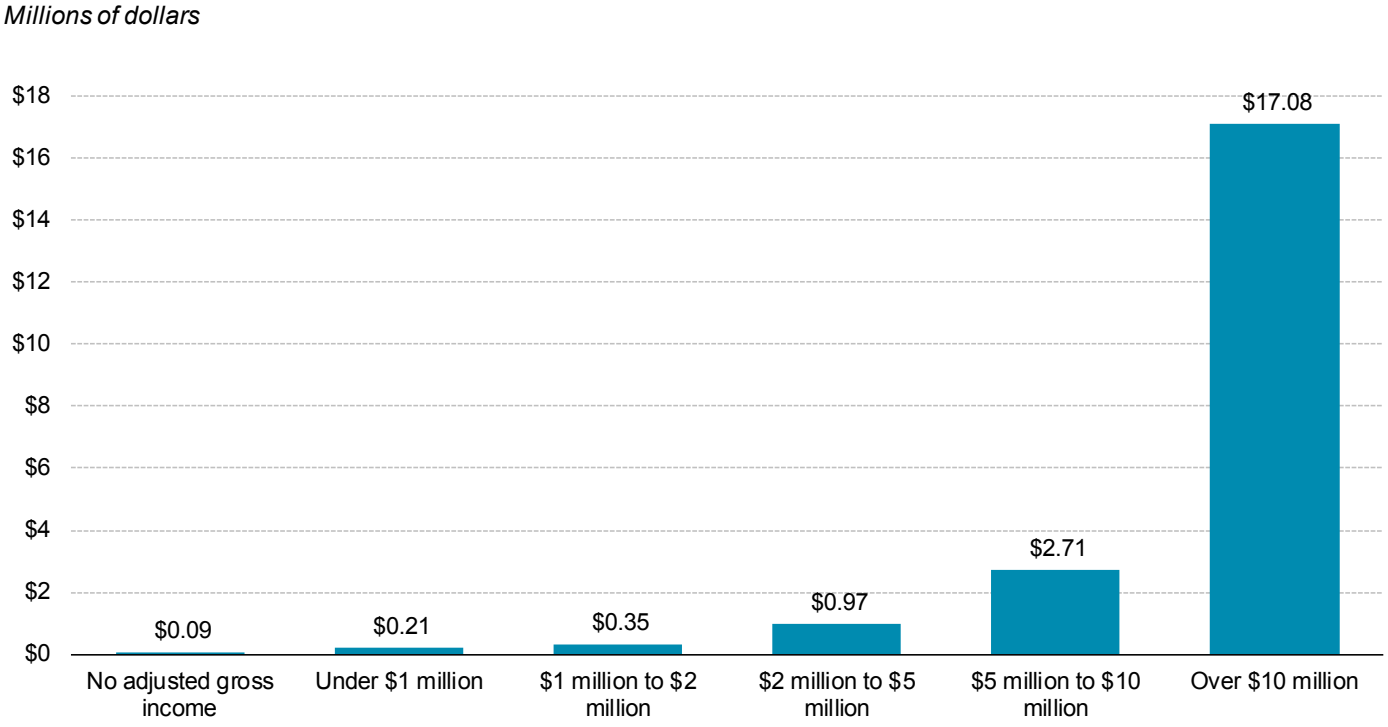
These planning opportunities are available only to the well off. More generally, capital assets are held predominantly by the well-off, who derive the most benefit from the capital gains preferences (figure 1).

Some may object that reducing the tax rate on capital gains is necessary to prevent "lock in"—holding property to defer tax liability (perhaps until death, when the tax basis of the asset is stepped up to permit heirs to sell without realizing any taxable gains). But if Congress is concerned about the lock-in effect, it could either tax capital gains at death or reinstate the carryover basis so that heirs retain the lower basis. Either step would reduce the tax incentive to keep assets until death—and could raise substantial revenue that would make it possible to reduce tax rates or the deficit.

How might the taxation of capital gains be improved?

FIGURE 1

Average Taxable Net Capital Gain by Adjusted Gross Income
2014



Source: IRS SOI, Table 1.4

Finally, if Congress is concerned about the potential double taxation of corporate earnings, it might integrate the two levels of taxes on corporate income. That is, Congress could tax corporate earnings only once, taxing the corporation or its shareholders but not both. The US Treasury (1992) has laid out several options for such integration.

How might the taxation of capital gains be improved?

Data Sources

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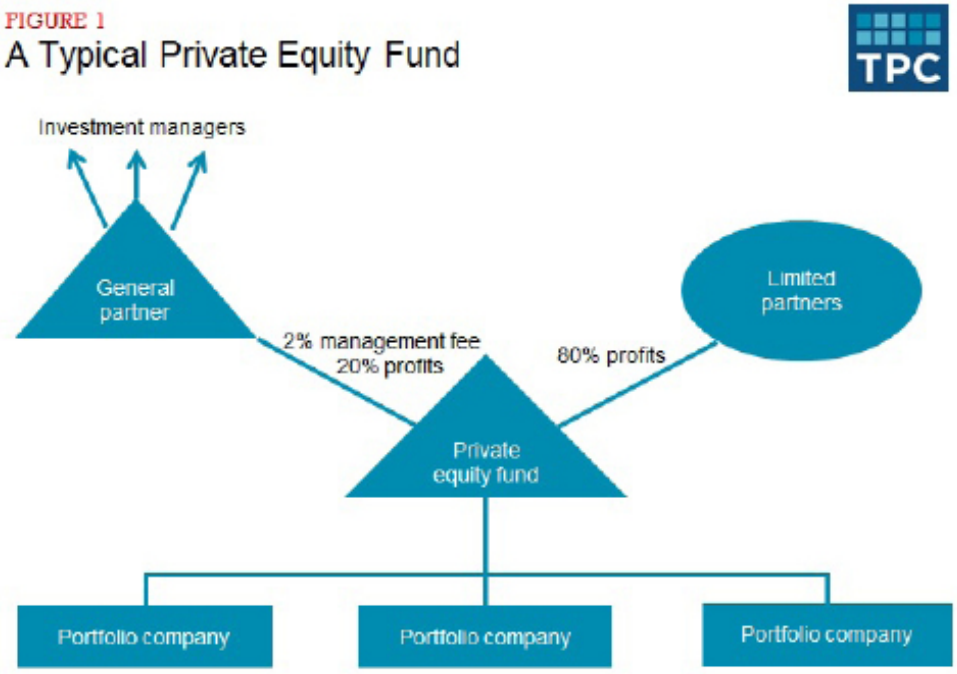
Q. What is carried interest, and should it be taxed as capital gain?

A. Carried interest, income flowing to the general partner of a private investment fund, is generally treated as capital gains for the purposes of taxation. This tax preference is viewed as an unfair, market-distorting loophole by some but consistent with the tax treatment of other entrepreneurial income by others.

Carried interest is a contractual right that entitles the general partner of a private investment fund (often a private equity fund) to share in the fund's profits (figure 1). A fund typically uses the carried interest to pass through its net capital gains to the general partner which, in turn, passes the gains on to the investment managers. The managers pay a federal personal income tax on these gains at a rate of 23.8 percent (20 percent tax on net capital gains plus 3.8 percent investment tax).

FIGURE 1
A Typical Private Equity Fund



Key Elements of the U.S. Tax System

What is carried interest and how should it be taxed?

The general partner receives its carried interest principally in exchange for its commitment to providing investment management services to the fund. (Typically, the general partner also receives a separate annual fee based on the size of the fund's assets.) The limited partners receive the balance of the fund's profits in exchange for providing predominantly all of the fund's capital. A typical division for a private equity fund is 20 percent of the profits to the general partner and 80 percent to the limited partners.

Private equity funds managed $3.8 trillion in 2014, a massive increase over the $100 billion managed in 1994. They use their capital to buy companies and improve the operations, governance, capital structure, and strategic positions of the companies. Then they sell the companies and pass any profits to the general and limited partners.

Many commentators argue that it would be fairer and more efficient economically for carried interest to be taxed like wage and salary income, which is subject to a top rate of 43.4 percent (39.6 percent plus 3.8 percent). They draw an analogy between the general partners and investment bankers, who pay tax at ordinary rates on their wages, salaries, and bonuses. They also object that most service providers are not able to treat their income as capital gains. Some of these commentators add, if we treat carried interest like wage and salary income for the general partners, we ought to allow ordinary deductions for these payments to the other investors.

But others believe that the general partners are more like entrepreneurs who start a new business and may, under current law, treat part of their return as capital—not as wage and salary income—for their contribution of "sweat equity." Our tax system largely accommodates this conversion of labor income to capital because it cannot measure and time the contribution of the "sweat equity."

Still others defend the current tax treatment of carried interest as a way to 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.

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Q. What is the AMT?

A. The individual alternative minimum tax (AMT) operates alongside the regular income tax. It requires many taxpayers to calculate their liability twice—once under the rules for the regular income tax and once under the AMT rules—and then pay the higher amount. Ori-gi-nally intended to prevent perceived abuses by a handful of the very rich, it now affects al-most 5 million filers.

In January 1969, Treasury Secretary Joseph W. Barr informed Congress that 155 taxpayers with incomes exceeding $200,000 had paid no federal income tax in 1966. The news created outrage. That year, members of Congress received more constituent letters about the 155 taxpayers than about the Vietnam War. Congress subsequently enacted an "add-on" minimum tax that house-holds paid in addition to regular income tax. It applied to certain income items ("preferences") that were taxed 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.

Congress enacted the modern alternative minimum tax (AMT) in 1979 to operate in tandem with the add-on minimum tax. The main preference items, including capital gains, moved from the add-on tax to the AMT. Congress finally repealed the add-on tax, effective in 1983.

The original minimum tax and the AMT affected fewer than 1 million taxpayers annually through the late 1990s. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which substantially reduced regular income taxes but provided only temporary relief from the AMT. Over the following decade, Congress repeatedly passed legislation—often at the last possible moment—to temporarily "patch" the AMT by increasing the AMT exemption amount.

Although the patches prevented an AMT explosion, the number of taxpayers affected by the AMT continued to grow throughout the decade (figure 1) because (1) the regular income tax was indexed for inflation, but the AMT was not; and (2) Congress enacted substantial cuts to the reg-ular income tax.

The American Taxpayer Relief Act of 2012 (ATRA) enacted a permanent AMT fix by establish-ing a higher AMT exemption amount, indexing the AMT parameters for inflation, and allowing specified tax credits under the AMT. As a result, the number of AMT taxpayers fell from 4.6 million in 2012 to about 4.2 million in 2013. That number will grow modestly to 4.8 million in 2017.

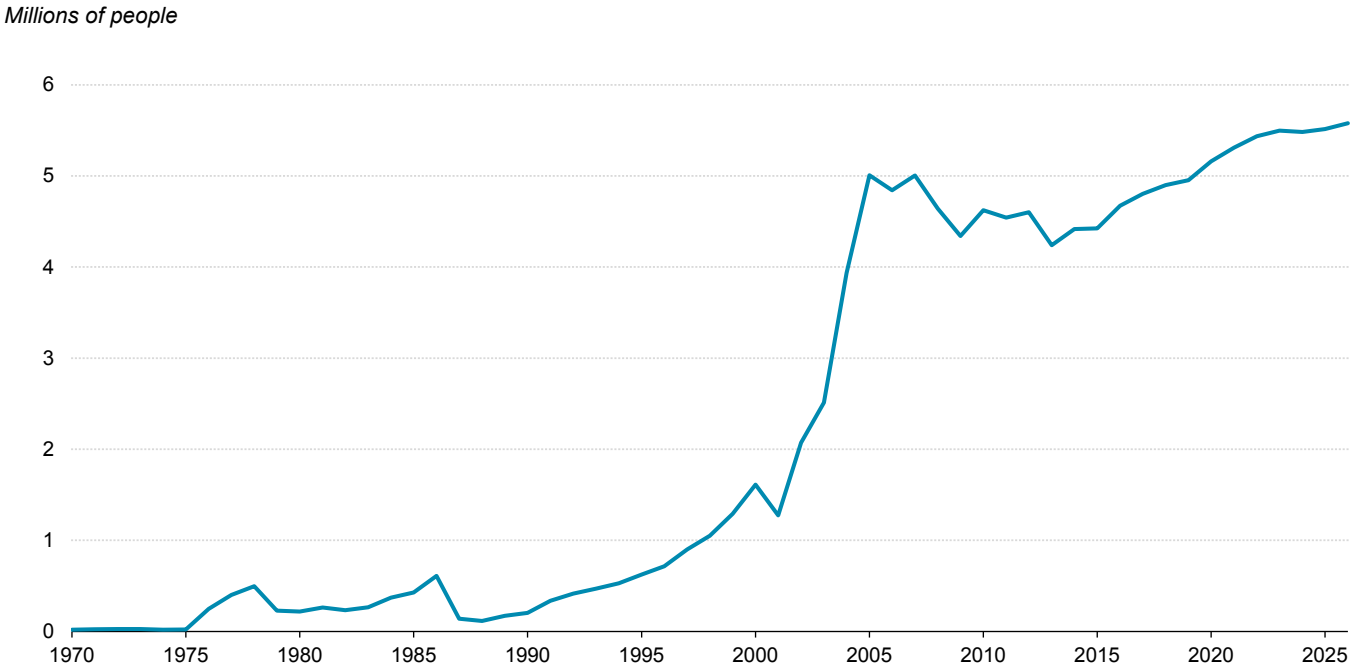
Key Elements of the U.S. Tax System

What is the AMT?

FIGURE 1

Taxpayers Affected by the AMT

1970–2026



Sources: Urban-Brookings Tax Policy Center Microsimulation Model; Harvey and Tempalski (1997); private communication from Jerry Tempalski; and IRS.
Notes: Figures include those who paid the original add-on minimum tax that Congress repealed in 1983. Taxpayers affected by the AMT include those with direct AMT liability on Form 6251 as well as those with lost credits and/or reduced deductions.

STRUCTURE

After calculating their regular income tax, many middle- and upper-income taxpayers must add a number of AMT "preference items" to their taxable income, subtract an AMT exemption amount, and recalculate their tax using the AMT tax rate structure. AMT liability is the excess, if any, of this amount over the amount of tax owed under the regular income tax rules.

AMT preference items include the deduction for state and local taxes (62 percent of all prefer-ences in 2012 according to Treasury data), personal exemptions (21 percent), the deduction for miscellaneous business expenses (9.5 percent), and the standard deduction (0.7 percent). The AMT also has special rules for the treatment of net operating losses and depreciation.

Because the AMT disallows the state and local tax deduction and dependent exemptions, fami-lies with children who live in high-tax states are among the most likely to owe AMT. Allowing the state and local tax deduction and dependent exemptions for AMT purposes would reduce the number of households affected by the AMT from 4.8 million to just 525,000 in 2017.

Key Elements of the U.S. Tax System

What is the AMT?

The AMT has two tax rates: the first $187,800 of income above the exemption is taxed at a 26-percent rate, and income above that amount is taxed at 28 percent. The AMT exemption begins to phase out at $129,700 for singles and heads of household, $160,900 for married couples filing jointly, and $80,450 for married couples filing separate returns. Because the exemption phases out at a 25-percent rate, it creates a top effective AMT tax rate of 35 percent (125 percent of 28 percent). All dollar values are for 2017 and are indexed annually for inflation (table 1).

TABLE 1

Alternative Minimum Tax Paremeters

Dollars, 2017

AMT Parameters	Single	Married filing jointly	Head of household	Married filing separately
Exemption	54,300	84,500	54,300	42,250
28 percent bracket threshold	187,800	187,800	187,800	93,900
Exemption phaseout threshold	120,700	160,900	120,700	80,450

Source: Internal Revenue Code.
Note: All parameters are indexed annually for inflation.

Data Sources

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Q. Who pays the AMT?

A. The individual alternative minimum tax (AMT) primarily affects well-off households, but not those with the very highest incomes. It is also more likely to hit taxpayers with large families, those who are married, and those who live in high-tax states.

Taxpayers pay the higher of either their tax calculated under regular income tax rules or their tax calculated under the alternative minimum tax (AMT) rules. Because the 39.6 percent top rate un-der the regular income tax is higher than the 28 percent top statutory AMT rate, households with very high incomes who do not attempt to shelter much income typically pay based on the regular income tax system. Households that are not at the very top but still have relatively high incomes face somewhat lower statutory tax rates under the regular tax and are therefore more likely to pay the AMT.

In 2017, 30.9 percent of households with "expanded cash income" (which is a broad measure of income) between $200,000 and $500,000 will be affected by the AMT (table 1). That number rises to 61.8 percent for those with incomes between $500,000 and $1 million. In contrast, only 18.2 percent of households with incomes greater than $1 million will be on the AMT.

TABLE 1

Share of Tax Units Affected by the AMT[a]

Thousands of dollars, 2016

Expanded cash income[b]	2016	2017	2026
Less than 50	c	c	c
50-75	c	c	c
75-100	0.3	0.3	0.3
100-200	1.9	2.0	2.2
200-500	30.3	30.9	28.5
500-1,000	62.9	61.8	69.1
1,000 and more	20.5	18.2	14.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

(a) Includes AMT liability on Form 6251, lost credits, and the value of reduced deductions. Tax units that are dependents of other tax units are excluded from the analysis.

(b) Tax units with negative adjusted gross income are excluded from their respective income classes but are included in the totals.

(c) Less than 0.05.

Who pays the AMT?

WHO PAYS?

The regular income tax allows a personal exemption of $4,050 (in 2017, indexed for inflation) for each family member. The AMT exemption varies by filing status but does not increase with family size. As a result, in 2017 families with two children are three times more likely to pay the AMT than those without children (6.3 percent versus 2.1 percent). Families with three or more children (9.0 percent) are more than four times as likely to pay the AMT as those without chil-dren (table 2).

TABLE 2

Share of Tax Units Affected by the AMT[a]

By individual characteristics

Group	2016	2017	2026
By number of children[b]			
0	2.1	2.1	2.2
1	3.7	3.8	4.2
2	6.1	6.3	7.1
3 or more	9.0	9.2	10.4
By state tax level			
High	4.9	5.0	5.4
Middle	2.7	2.8	3.0
Low	2.4	2.4	2.4
By filing status			
Single	0.9	1.0	1.1
Married Filing Joint	6.2	6.4	6.5
Head of Household	2.0	2.1	2.5
Married Filing Separate	6.3	6.0	7.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

(a) Includes AMT liability on Form 6251, lost credits, and the value of reduced deductions. Tax units that are de-pendents of other tax units are excluded from the analysis.

(b) Number of children is defined as number of exemptions taken for children living at home.

Under the regular income tax, many married couples receive a "marriage bonus" because they pay less tax than they would if they were single. This is not true under the AMT. AMT tax brackets are identical for married and single taxpayers, and the AMT exemption for married couples is only about one and a half times as large as the exemption for singles. In contrast, the standard deduction for married couples under the regular income tax is twice that for singles, and the 10 and 15 percent 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 incomes than single individuals, make married couples more than six times as likely as singles to pay the AMT.

Taxpayers can deduct state and local taxes under the regular income tax but not the AMT. Thus, in 2017 taxpayers in high-tax states are more than twice as likely to be on the AMT as those in low-tax states.

Who pays the AMT?

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Q. How much revenue does the AMT raise?

A. About $35 billion in 2017, or about 2.2 percent of all individual income tax revenue. By 2026, AMT revenue will total $57 billion, or 2.3 percent of all individual income tax reve-nue.

Congress enacted the original minimum tax in 1969. It was an "add-on" tax that households paid in addition to any regular income tax they owed. It applied to certain income items ("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. Revenue from the add-on tax grew from $122 million (0.14 percent of aggregate individual income tax revenue) in 1970 to $1.5 billion (0.84 percent) by 1978.

Congress enacted the modern individual alternative minimum tax (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 new AMT. As a result, revenue from the add-on tax plummeted to $300 million in 1979. Congress subsequently repealed the add-on tax, effective in 1983. Revenue from the new AMT climbed rapidly from $870 million (about 0.4 percent of all individual income tax revenue) in its inaugural year of 1979 to $6.7 billion (2.0 percent) in 1986.

The Tax Reform Act of 1986 (TRA) changed both the regular income tax and the AMT. The TRA eliminated much tax sheltering activity and thus shifted much of the AMT base to the regular income tax system. In particular, the TRA eliminated the partial exclusion of capital gains, which had accounted for 85 percent of total AMT preferences in 1985. As a result, AMT revenue fell to $1.7 billion in 1987, back to the same 0.4 percent of aggregate individual income tax revenue that it had raised in 1979.

Unlike the regular income tax system, Congress did not index the AMT for inflation. Each year, the standard deduction, personal exemptions, and tax bracket thresholds in the regular income tax would rise to keep pace with inflation. In contrast, the AMT exemption and brackets stayed fixed. Thus, over time, as a taxpayer's income rose with inflation, AMT liability rose relative to regular income tax liability. Because taxpayers paid the larger of the two taxes, inflation pushed more people onto the AMT, and AMT revenue increased steadily after 1987.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which substantially reduced regular income taxes but provided only temporary relief from the AMT. Over the following decade, Congress repeatedly passed legislation—known as the AMT "patch"—to prevent an explosion in the number of AMT payers. Despite the annual patches, AMT revenue continued to grow, reaching $36.6 billion in 2012.

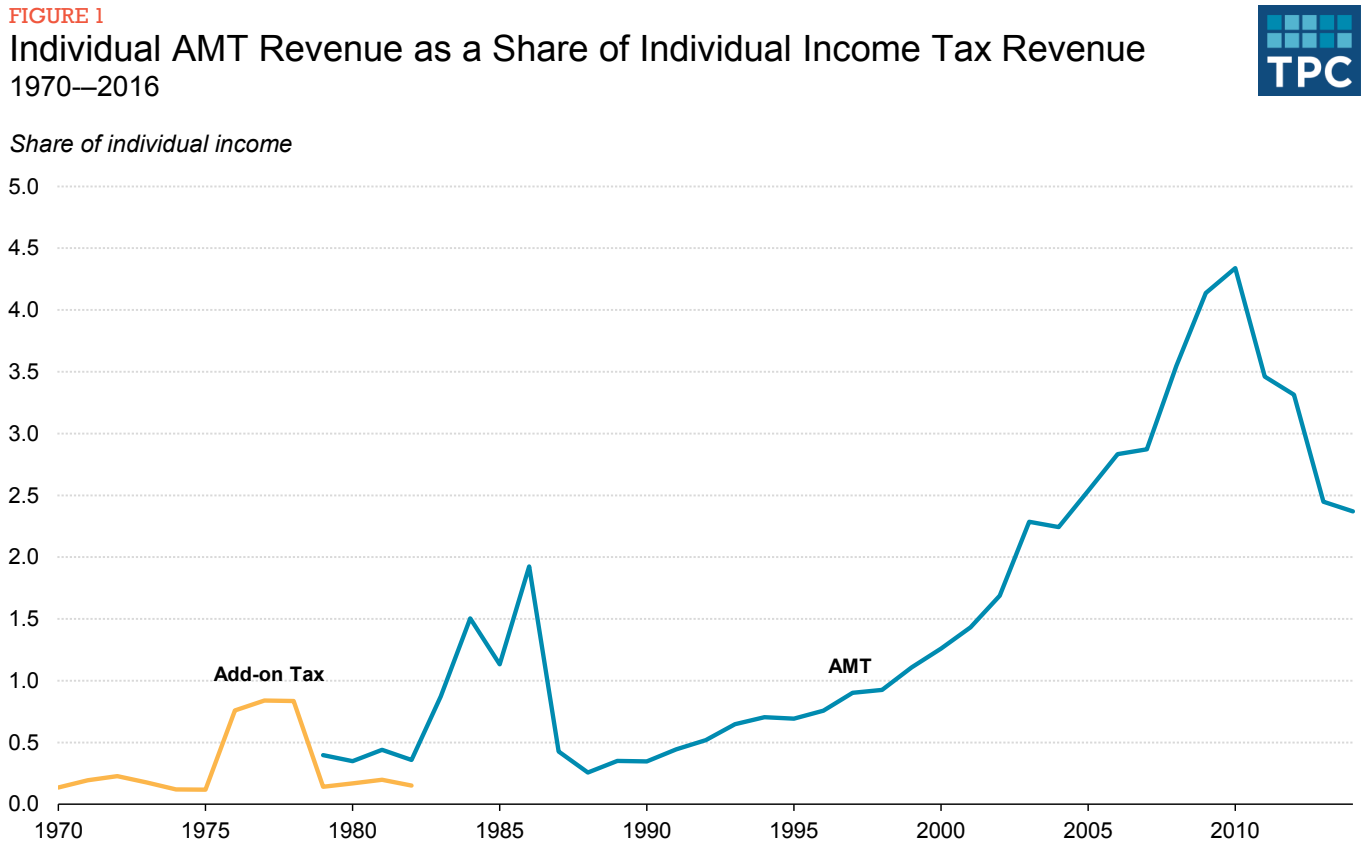
Key Elements of the U.S. Tax System

How much revenue does the AMT raise?

The American Taxpayer Relief Act of 2012 (ATRA) finally enacted a permanent AMT "fix" by establishing a higher AMT exemption, indexing the AMT parameters for inflation, and allowing certain tax credits under the AMT. Combined with the fact that ATRA raised regular income taxes on high-income taxpayers, the permanent AMT fix reduced AMT revenue to $28.4 billion in 2013.

FIGURE 1

Individual AMT Revenue as a Share of Individual Income Tax Revenue
1970–2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model (versions 0304-3, 1006-1, 0308-7, 0309-1, 0509-2, 0411-1, and 0516-1); Harvey and Tempalski (1997); private communication from Jerry Tempalski; and IRS.

PROJECTIONS

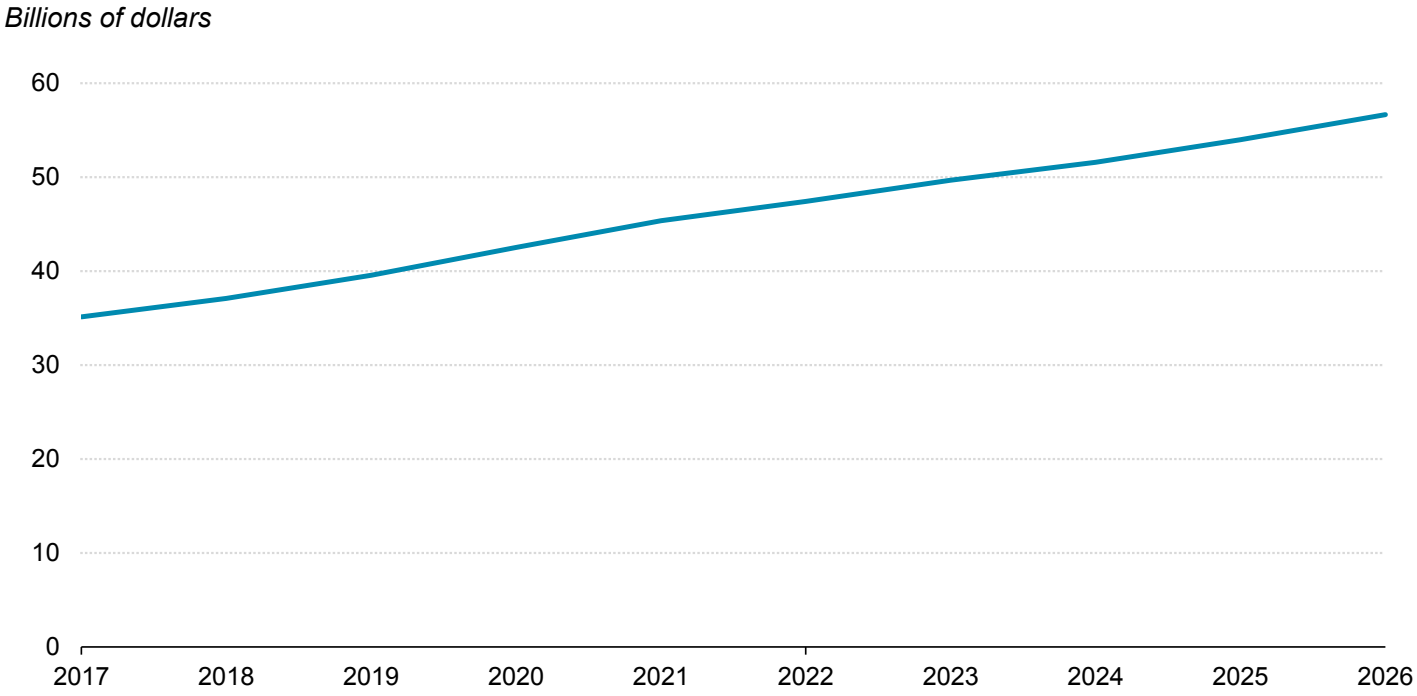
In 2017, the AMT is expected to generate $35.1 billion, or about 2.2 percent of individual income tax revenue. Despite ATRA's permanent fix to the AMT, real income growth over the coming decade will push more taxpayers into the income ranges hit by the tax. Thus, AMT revenue is projected to grow to $56.6 billion by 2026 (figure 2), even though the AMT's share of total individual income tax revenue will remain roughly constant.

Key Elements of the U.S. Tax System

How much revenue does the AMT raise?

FIGURE 2

Projected AMT Revenue
2017–26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Data Sources

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Q. Did ATRA fix the AMT?

A. The American Taxpayer Relief Act of 2012 (ATRA) prevented an explosion in the number of tax filers ensnared by the AMT. Nonetheless, some 4.8 million will pay the AMT in 2017.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) substantially cut the regular individual income tax through 2010, but provided only limited and temporary relief from the individual alternative minimum tax (AMT) through 2004. The lack of a permanent solution required Congress to revisit the AMT every year or two and pass a short-term fix or "patch" to prevent the tax from ensnaring tens of millions of households. The patches typically limited the AMT's reach by raising the exemption level and allowing certain personal credits to be used under the AMT.

The American Taxpayer Relief Act of 2012 (ATRA) made permanent most of the tax cuts enacted over the previous decade and finally created a permanent AMT fix. In addition to raising the AMT exemption, ATRA indexed the AMT parameters for inflation and permanently allowed certain tax credits—such as the child tax credit and credits for postsecondary education expenses—to be used under the AMT. The Joint Committee on Taxation estimated the 10-year cost of the AMT relief in ATRA at more than $1.8 trillion.

Under ATRA, the number of taxpayers affected by the AMT is expected to increase from 4.8 million in 2017 to 5.6 million by 2026 (figure 1). If ATRA had not included an AMT fix, 46.6 million taxpayers would have faced the AMT in 2017. That number would have increased to 79.1 million by 2026.

Under ATRA, AMT revenue is projected to increase from $35.1 billion in 2017 to $56.6 billion in 2026 (figure 2). Without the ATRA fix, the tax would have generated $215.4 billion in 2017, increasing to $475.1 billion by 2026.

Although ATRA prevented an AMT explosion, it did not completely eliminate the problems associated with the tax. The original purpose of the minimum tax, the precursor to today's AMT, was to prevent high-income households from sheltering significant amounts of income and to ensure that those households paid at least some income tax. The current version of the AMT strays from that original goal.

Most taxpayers find themselves on the AMT not because they engage in egregious tax sheltering but because they are married, have large families, or live in high-tax states. Data from the Treasury Department show that in 2012, the largest differences between taxable income under the regular income tax and under the AMT result from the AMT's disallowance of the state and local tax deduction (62 percent of difference) and personal exemptions (21 percent) (figure 3). Allowing those items under the AMT would reduce the number of taxpayers affected by the tax in 2017 from 4.8 million to 525,000.

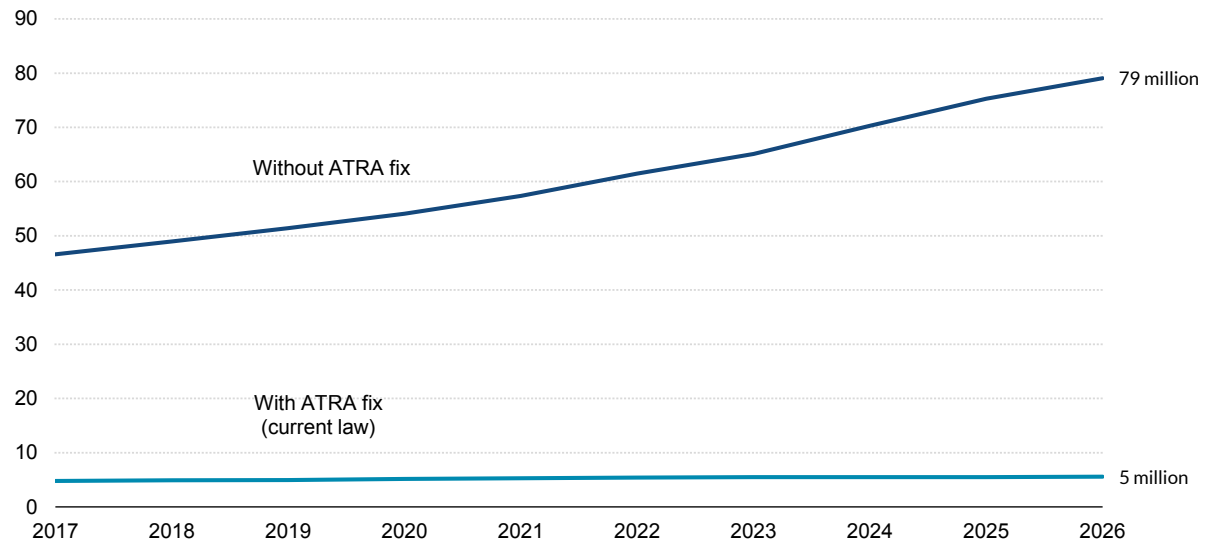
Key Elements of the U.S. Tax System

Did the American Taxpayer Relief Act of 2012 (ATRA) fix the AMT?

FIGURE 1

Effect of ATRA Fix on Number of AMT Payers
2017-26

Millions of taxpayers

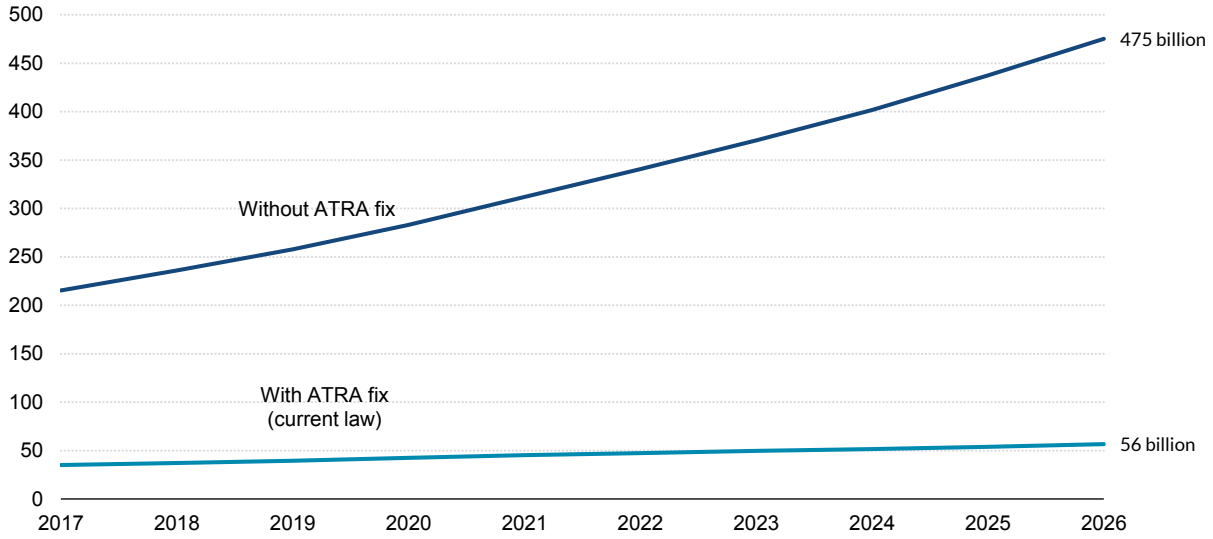


Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: AMT payers include those with direct AMT liability on Form 6251 as well as those with lost credits and/or reduced deductions.

FIGURE 2

Effect of ATRA Fix on AMT Revenue
2017-26

Billions of dollars



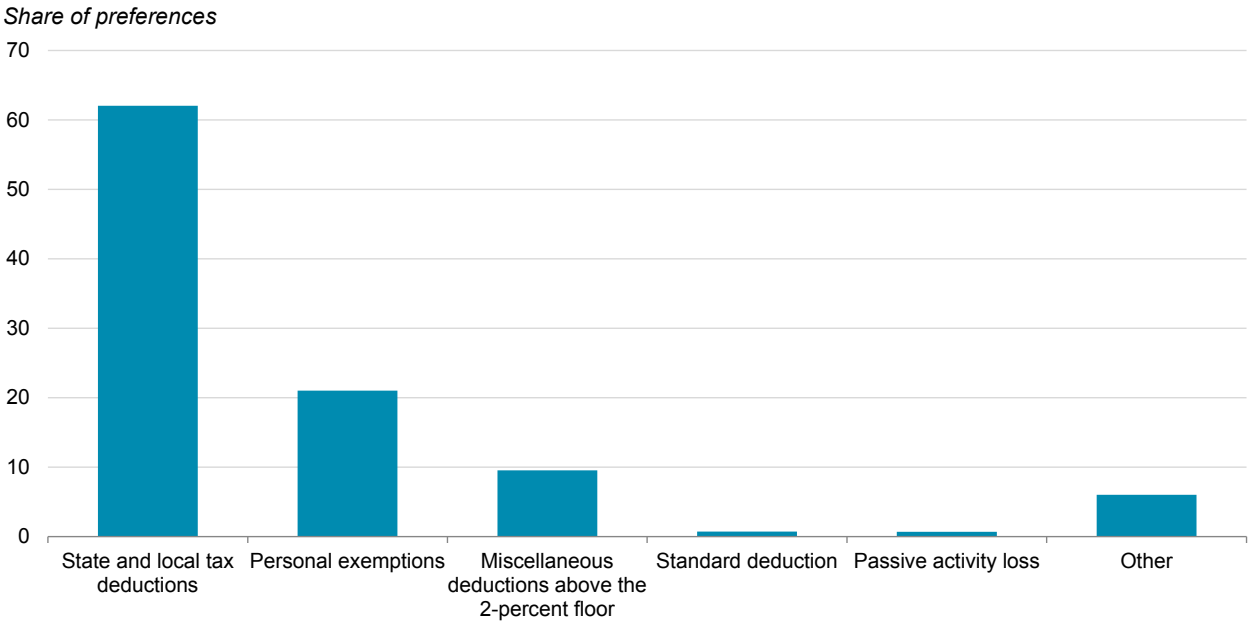
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: AMT payers include those with direct AMT liability on Form 6251 as well as those with lost credits and/or reduced deductions.

Did the American Taxpayer Relief Act of 2012 (ATRA) fix the AMT?

FIGURE 3

AMT Preference Items as a Share of Total Positive Preferences

2012



Source: Office of Tax Analysis, Department of the Treasury (unpublished tabulations).
Notes: Regular tax net operating losses (NOLs) represent 3.0 percent of positive preferences but are partially offset by AMT NOLs, which are a negative preference.

A true AMT "fix" would likely involve either retargeting the tax to hit aggressive tax sheltering or broadening the base of the regular income tax to eliminate the need for an alternative tax in the first place.

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Q. Should the AMT replace the regular income tax?

A. The notion that taxpayers should not have to calculate their tax liability twice—once for the regular tax and again for the alternative minimum tax (AMT)—has merit. It is less clear that making the AMT the only income tax in town would improve the tax system's efficiency, simplicity, or fairness.

TWO RATES OR FOUR?

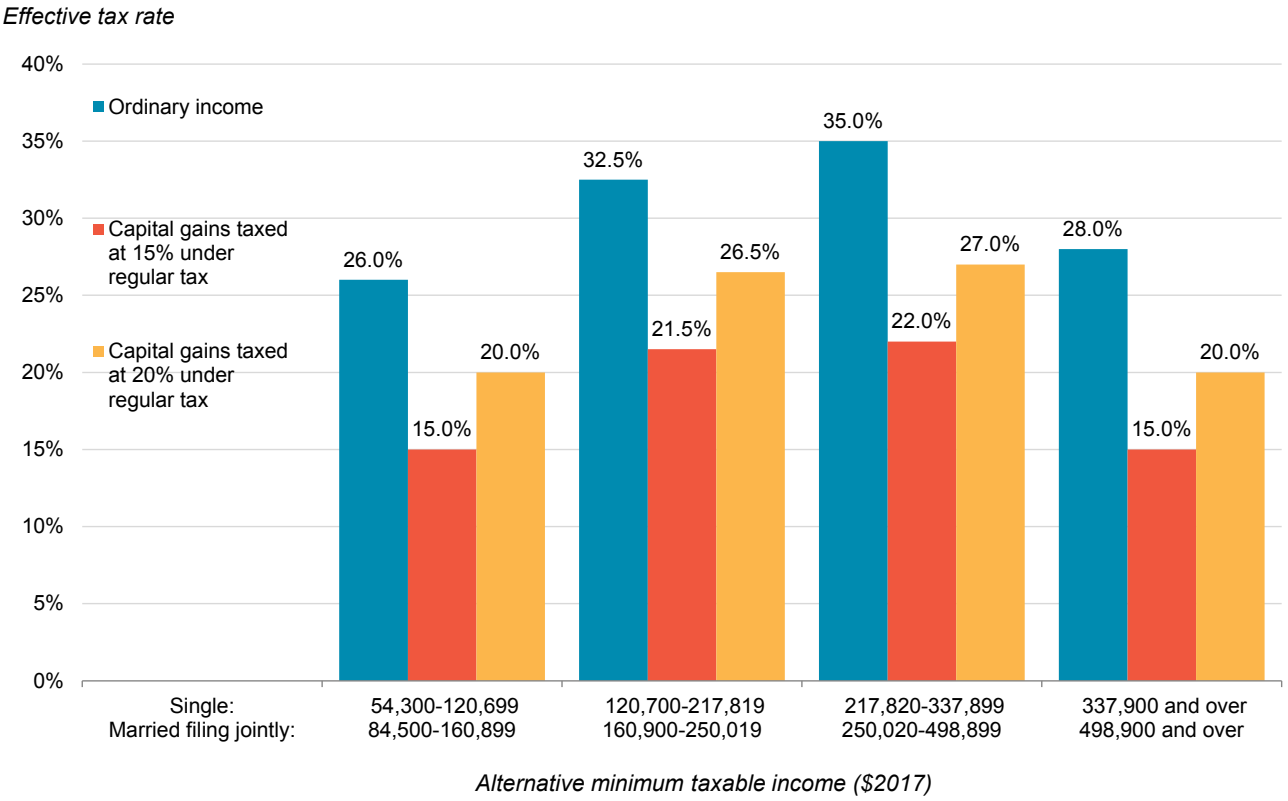
The regular income tax has seven statutory tax rates ranging from 10 percent to 39.6 percent. The AMT has only two: 26 percent and 28 percent. But the AMT is not as flat as it seems. It actually imposes four marginal tax rates, not two, because the AMT exemption phases out as income rises (figure 1).

The AMT exemption falls by 25 cents for each dollar by which alternative minimum taxable income exceeds a threshold ($160,900 for married couples and $120,700 for singles in 2017; those amounts are indexed annually for inflation). Thus, over the income range where the exemption phases out, taxpayers actually face a marginal rate 25 percent higher than the statutory rate. This increase applies not only to an additional dollar of ordinary income, but also to any increase in long-term capital gains or qualified dividends. So although the AMT is advertised as preserving the preferential rates on gains and dividends, over certain income ranges it actually taxes those income sources more heavily than the regular income tax.

FIGURE 1

Effective AMT Rates on Ordinary Income and Capital Gains

2017



Sources: Internal Revenue Code and author's calculations.
Notes: Under the regular income tax, the maximum tax rate is 20 percent on any amount of adjusted net capital gain that otherwise would be taxed at a 39.6 percent rate. Any gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Gains otherwise taxed at rates greater than 15-percent but less than 39.6 percent are taxed at a 15-percent rate. All rates in this analysis exclude the potential effects of the 3.8 percent surtax on net investment income.

LOWER RATES ON A BROADER BASE?

The notion that the AMT taxes a broader income base at a lower rate than the regular income tax is not true for most AMT payers. In 2017, about 79 percent of households on the AMT actually face a higher effective marginal tax rate than they would if they were on the regular income tax (table 1).

In addition, the AMT provides a large exemption of $84,500 for married couples and $54,300 for singles in 2017; those amounts are indexed annually for inflation. This means that the amount of income taxed under the AMT is often less than under the regular income tax. In 2017, about 69 percent of taxpayers affected by the AMT would have had more income subject to tax under the rules of the regular system than under the AMT.

TABLE 1

Income Subject to Tax and Effective Marginal Tax Rates Under the Regular Income Tax and AMT

By share of AMT taxpayers, 2017[a]

Expanded cash income (thousands of 2016$)[b]	Percent with More Income Subject to Tax Under: [c]		Percent with a Higher Marginal Tax Rate Under: [d]	
	Regular Tax	AMT	Regular Tax	AMT
Less than 75	n/a	n/a	n/a	n/a
75-100	93.6	6.4	1.8	97.3
100-200	90.5	9.5	1.2	95.6
200-500	79.1	20.9	11.8	87.3
500-1,000	15.6	84.4	59.6	40.0
More than 1,000	11.7	88.3	67.8	28.7
All	**68.8**	**31.3**	**19.4**	**79.3**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Notes: n/a = not applicable (insufficient number of AMT taxpayers in this income range.

(a) Calendar year. AMT taxpayers include those with AMT liability from Form 6251, with lost credits, and with reduced deductions.

(b) Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. Includes both filing and non-filing units but excludes those that are dependents of other taxpayers. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.

(c) Income subject to tax for the regular income tax is taxable income; for the AMT it is AMTI net of the AMT exemption.

(d) The marginal tax rate for each return is calculated by adding $1,000 to wages, recomputing income tax net of refundable credits, and dividing the resulting change in tax liability by 1,000.

SIMPLER AND FAIRER?

Making the AMT the only income tax would certainly reduce the hassle involved in calculating taxes twice. But the AMT as a stand-alone tax would still retain much of the complexity of the current regular tax system, particularly with respect to the definition and treatment of business and capital income.

In addition, the AMT imposes significant marriage penalties. Under the regular tax the standard deduction for married couples is twice that for singles, and the 10- and 15-percent tax brackets for married couples are twice as wide as those for singles. In contrast, AMT tax brackets are identical for married and single taxpayers, and the AMT exemption for married couples is only about one and a half times as large as the exemption for singles.

The regular income tax allows a personal exemption of $4,050 (in 2017, indexed for inflation) for each family member. The AMT exemption varies by filing status, but does not increase with family size. As a result, compared with the regular income tax, the AMT places a higher burden on large families.

Finally, because the tax rate on the highest incomes under the AMT is only 28 percent—significantly less than the regular tax's top statutory rate of 39.6 percent—the AMT places a lighter burden on those with the greatest ability to pay.

Should the AMT replace the regular income tax?

Data Sources

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Q. How might we improve the AMT?

A. Congress could retarget the AMT to its original purpose or enact a major overhaul of the income tax system, eliminating the need for an alternative tax.

REFORM OPTIONS

The Family Fix

The regular income tax allows a personal exemption of $4,050 (in 2017, indexed for inflation) for each family member. The individual alternative minimum tax (AMT) exemption varies by filing status but does not increase with family size. One possible reform option, a "family fix," would allow dependent exemptions under the AMT. To mitigate marriage penalties, the proposal would also set the AMT exemption, 28 percent bracket threshold, and exemption phase-out threshold for married couples at twice the value for singles. This option would cost $172.7 billion over 10 years (figure 1) and would reduce the number of AMT taxpayers by more than 3.5 million (figure 2).

The Deduction Fix

Another option, a "deduction fix," would allow state and local taxes, miscellaneous expenses above the 2 percent of adjusted gross income floor, and the standard deduction to be allowable under the AMT. This reform option would cost $352.6 billion over 10 years and would reduce the number of AMT taxpayers to about 400,000.

Taxing Capital Gains

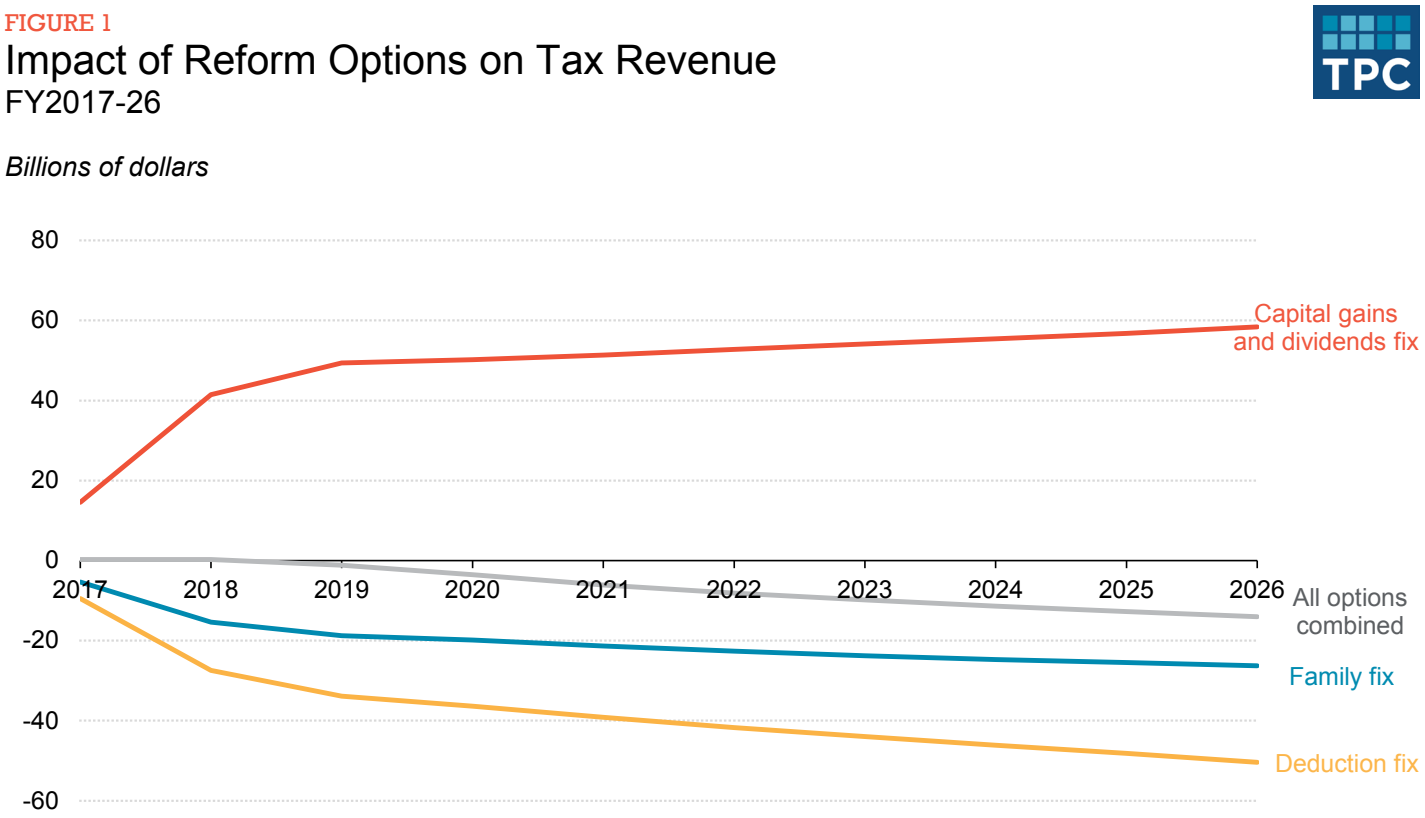
Under current law, capital gains and qualified dividends generally receive the same preferential treatment under the AMT and the regular income tax. A third option would tax capital gains and qualified dividends at the same rate as ordinary income under the AMT. This option would generate $268 billion over 10 years and would increase the number of AMT taxpayers by about 1 million annually.

A major AMT overhaul combining all three of the above options would cost $229.5 billion over 10 years, and would decrease the number of AMT taxpayers to about 500,000.

FIGURE 1

Impact of Reform Options on Tax Revenue

FY2017-26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: Baseline is current law. Proposals are effective 01/01/2016. Estimates include a microdynamic behavioral response. Estimates assume a 40-60 fiscal split, i.e. fiscal year revenue is estimated to be 60 percent of revenue from the previous calendar year plus 40 percent of revenue from the current calendar year.

Overhaul

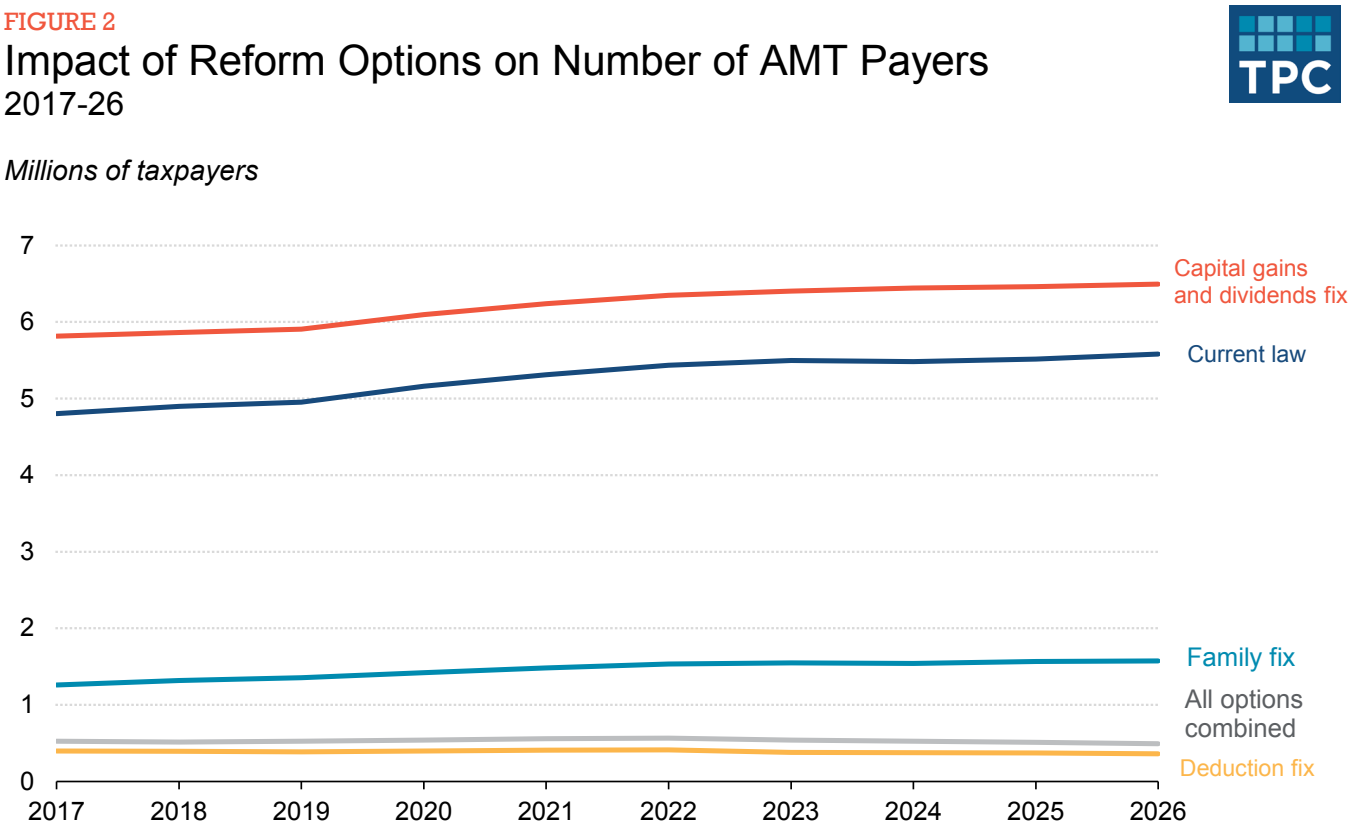
An alternative to this sort of incremental reform would be to combine the AMT's repeal with a major reform of the individual income tax that would prevent the sheltering behavior that the minimum tax was originally designed to prevent. Stand-alone repeal of the AMT would cost $388.9 billion over the next 10 years.

Key Elements of the U.S. Tax System

How might we improve the AMT?

FIGURE 2

Impact of Reform Options on Number of AMT Payers
2017-26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Note: AMT payers include those with direct AMT liability on Form 6251, lost credits, and reduced deductions.

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0516-1."

Further Reading

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Q. What is the personal exemption?

A. Personal exemptions for both taxpayers and dependents provide that only a person's income above some defined basic level is subject to tax. This helps ensure that the poorest households are not subject to the income tax. In 2017, the personal exemption is $4,050.

In 2014, tax filers reported $9.7 trillion in adjusted gross income (AGI) and claimed $1.1 trillion in personal exemptions (although, as explained below, not all exemptions could be fully utilized to reduce tax liability).

In 1913, the personal exemption was set at $3,000 (worth more than $70,000 in today's dollars), so that very few persons were expected to pay tax. The 2017 personal exemption, at $4,050, is substantially lower both in real terms and relative to average incomes. 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. Think of it as a first tax bracket at a zero rate. For instance, a single taxpayer who would otherwise owe 15 percent on his or her first $4,000 of income saves $600, whereas a single taxpayer in a 35 percent bracket saves $1,400. Thus, under a progressive income tax, exemptions are worth more to high-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.

The personal exemption also links tax liability to household size. For instance, it implies that a household of four with $116,200 of taxable income (before subtracting personal exemptions) and a household of two with $108,100 of taxable income (before subtracting personal exemptions) are deemed to have the same ability to pay tax—in this case on $100,000.

Since 1990, the personal exemption has been phased out at higher income levels. In 2017, the phaseout begins for single filers at $261,500 and married filing jointly taxpayers at $313,800. It phases out completely at $384,000 for single filers and $436,300 for married filing jointly taxpayers. Under the American Taxpayer Relief Act of 2012, the thresholds are indexed for inflation.

The alternative minimum tax (AMT) denies taxpayers the use of personal exemptions. This feature is the second-largest source of tax increase in the AMT. As a result, larger families are more likely to owe AMT than smaller families.

Key Elements of the U.S. Tax System

What is the personal exemption?

Data Sources

Internal Revenue Service. 2016. Statistics of Income—Individual Income Tax Returns Publication 1304 (Complete Report). Washington, DC: Internal Revenue Service.

Further Reading

Carasso, Adam, and C. Eugene Steuerle. 2003. "Personal Exemption Not What It Used to Be." *Tax Notes*, April 28.

Q. Has the personal exemption kept up with prices and incomes?

A. Both the relative and the real value of the personal exemption have fallen since its creation in 1913, although other tax credits have helped offset its reduction. The personal exemption is now indexed to inflation.

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

The personal exemption in 1948 was $600. Had it been indexed to prices beginning in 1948, its value in 2015 would have been $5,900 rather than the actual $4,000 (figure 1). Setting the exemption at that higher level would, however, reduce revenues by about $60 billion.

Had the personal exemption been indexed to personal income per capita since 1948, it would have been $19,800 in 2015, almost five times what it actually is, and annual revenues would fall more than $298 billion below current levels.

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

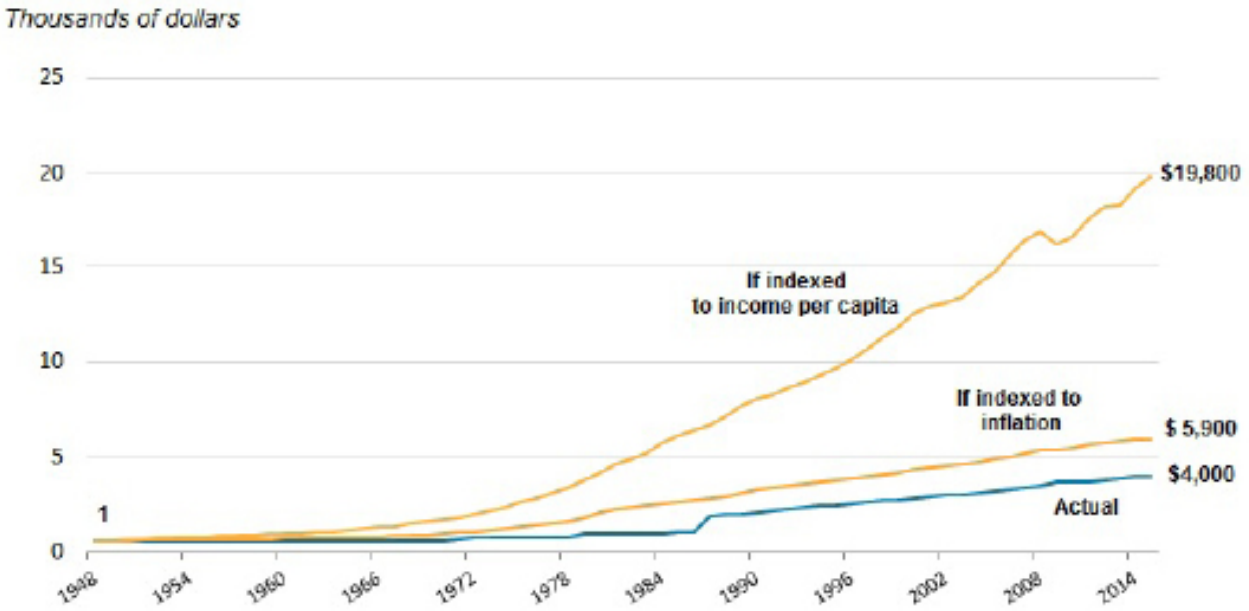
Key Elements of the U.S. Tax System

Has the personal exemption kept up with prices and income?

FIGURE 1

Growth of the Personal Exemption

Actual and with indexing, 1948-2015



Source: Urban-Brookings Tax Policy Center; Internal Revenue Service; Bureau of Economic Analysis, National Income and Product Accounts, table 2.1.

Key Elements of the U.S. Tax System

Has the personal exemption kept up with prices and income?

TABLE 1

Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2015[1]

Percentages and 2015 Dollars

	Increase Personal Exemption to $5,900[1]			Increase Personal Exemption to $19,800[2]		
Expanded Cash Income Percentile[3,4]	Percent of Tax Units with Tax Cut[5]	Average Federal Tax Change ($)	Percentage Point Change in Average Federal Tax Rate[6]	Percent of Tax Units with Tax Cut[5]	Average Federal Tax Change ($)	Percentage Point Change in Average Federal Tax Rate[6]
Lowest Quintile	13.9	(20)	(0.2)	14.0	(60)	(0.5)
Second Quintile	57.7	(170)	(0.5)	57.8	(760)	(2.2)
Middle Quintile	86.6	(430)	(0.7)	86.7	(2,120)	(3.5)
Fourth Quintile	97.1	(750)	(0.7)	97.2	(4,310)	(4.1)
Top Quintile	75.8	(910)	(0.3)	76.6	(3,800)	(1.2)
All	53.7	(380)	(0.5)	53.9	(1,830)	(2.2)
Addendum						
80-90	95.9	(1,160)	(0.7)	96.2	(5,380)	(3.2)
90-95	83.9	(1,050)	(0.4)	85.4	(3,540)	(1.5)
95-99	29.7	(280)	(0.1)	31.0	(820)	(0.2)
Top 1 Percent	0.5	-	-	0.6	(10)	-
Top 0.1 Percent	0.2	-	-	0.2	(20)	-

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-2).

(1) Calendar year. Proposal would increase the personal exemption amount to $5,900.
(2) Calendar year. Proposal would increase the personal exemption amount to $19,800.
(3) Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see http://www.taxpolicycenter.org/resources/income-measure-used-distributional-analyses-tax-policy-center.
(4) The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2015 dollars): 20%: $23,800; 40%: $46,800; 60%: $81,000; 80%: $140,900; 90%: $204,900; 95%: $291,000; 99%: $688,900; 99.9%: $3,438,600.
(5) Includes tax units with a change in federal tax burden of $10 or more in absolute value.
(6) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes) as a percentage of average expanded cash income.

Data Sources

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Further Reading

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Steuerle, C. Eugene. 2008. *Contemporary U.S. Tax Policy*. 2nd ed. Washington, DC: Urban Institute Press.

Q. What is the child tax credit?

A. The child tax credit (CTC) provides a credit of up to $1,000 per child under age 17. If the CTC exceeds taxes owed, families may receive some or all of the credit as a re-fund, known as the additional child tax credit (ACTC) or refundable CTC.

HOW THE CTC WORKS TODAY

Taxpayers can claim a tax credit of up to $1,000 for each child under age 17. The credit is reduced by 5 percent of adjusted gross income over $75,000 for single parents ($110,000 for married couples). 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 $3,000.

FIGURE 1

Child Tax Credit for One Child

Source: Tax Policy Center.
Note: Assumes all income comes from earning and child is under 17 and meets all tests to be a CTC qualfiying child.

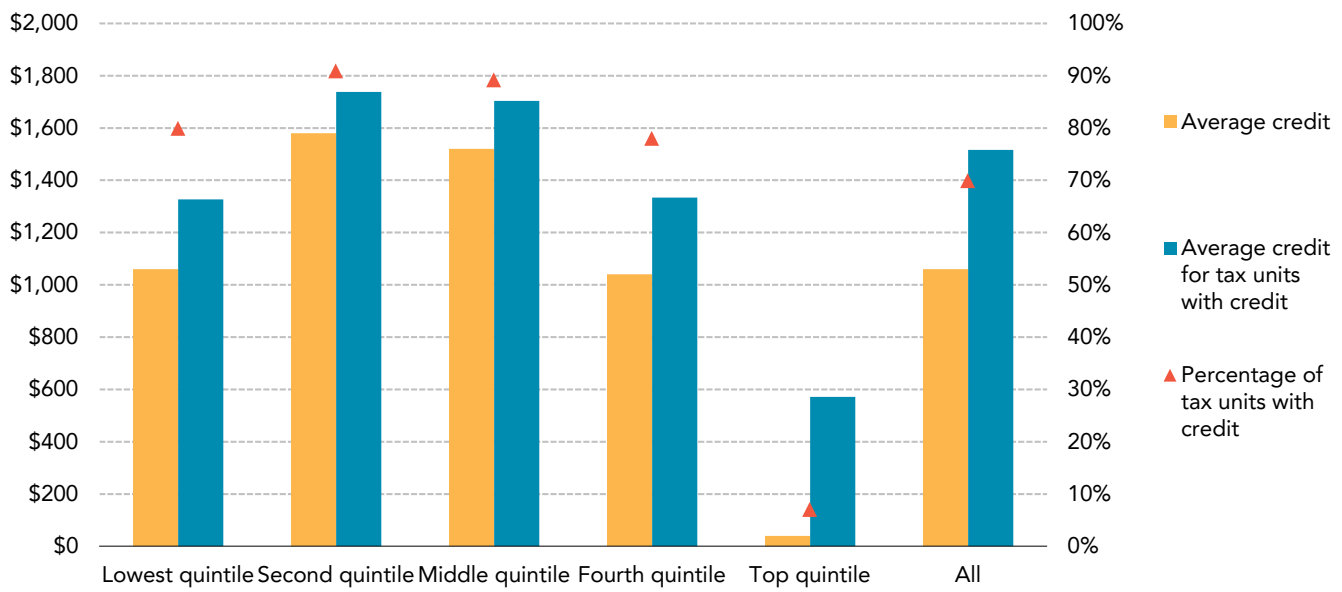
IMPACT OF THE CTC

Families in all income groups benefit from the CTC. However, the percentage of families receiving the credit and the average credit received is higher among moderate- and middle-income families. In 2016, 70 percent of families with children will receive an average CTC of $1,060. About 90 percent of families with children in the second and third income quintiles receive CTC benefits (each quintile contains 20 percent of the population ranked by household income). The proportion of families with children receiving a credit drops to 80 percent in the fourth quintile, while only 7 percent of families with children in the highest income quintile receive the credit (figure 2).

FIGURE 2

Distribution of and Percentage of Tax Units with Children and Child Tax Credit

2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0516-1).

If the CTC (including the refundable portion) were counted in the official estimate of poverty, 2.8 million fewer people would fall below the poverty threshold in 2015, including about 1.6 million children. Counting the credit would have also reduced the severity of poverty for an additional 13.3 million people, including 6.6 million children (Center on Budget and Policy Priorities 2016).

RECENT HISTORY OF THE CREDIT

The American Taxpayer Relief Act of 2012 (ATRA) permanently increased the CTC from $500 per child, its pre-2001 level, to $1,000 per child. It also temporarily extended the provisions of the American Recovery and Reinvestment Act of 2009 (the anti-recession stimulus package) that reduced the earnings threshold for the refundable CTC from $10,000 (adjusted for inflation starting after 2002) to $3,000 (not adjusted for inflation). The Bipartisan Budget Act of 2015 made the $3,000 refundability threshold permanent.

The refundable CTC was originally designed in 2001 to coordinate with the earned income tax credit (EITC). Once earnings reached $10,020 for families with two children in 2001, there was no further increase in the EITC. The earnings threshold for the refundable CTC was set at $10,000 so families could now receive a subsidy for earnings in excess of that amount. Like the earned income amount for the EITC, the $10,000 earnings threshold was indexed for inflation. When the earnings threshold for the refundable CTC was reduced—first to $8,500 in 2008 and then to $3,000 in 2009—that link between the phase in of the refundable CTC and the EITC was broken.

Data Sources

Urban-Brookings Tax Policy Center. Microsimulation Model, version 0516-1.

Further Reading

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Maag, Elaine, and Lydia Austin. 2014. "Implications for Changing the Child Tax Credit Refundability Threshold." *Tax Notes*, July 24.

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Q. What is the adoption tax credit?

A. The tax code provides an adoption credit of up to $13,570 of qualified expenses (in 2017) for each child adopted, whether via public foster care, domestic private adoption, or international adoption. The tax expenditure on the credit in 2015 totaled approximately $300 million.

CREDIT AMOUNT

Taxpayers can receive a tax credit for all qualifying adoption expenses up to $13,570 in 2017. The maximum credit is indexed for inflation. Taxpayers may also exclude from income qualified adoption expenses that are paid or reimbursed by an employer, up to the same limit as the credit. Taxpayers can use the tax credit and the income exclusion but cannot claim the same expenses for both.

"Special needs" adoptions automatically qualify for the maximum credit regardless of actual out-of-pocket expenses. For purposes of the credit, a child has special needs if a state's welfare agency determines that the child cannot or should not be returned to his or her parents' home and that the child probably will not be adoptable without assistance provided to the adoptive family. This provision is designed to encourage parents to adopt children who would otherwise be hard to place, even if most of the adoption expenses are covered by someone else (such as a public foster care program).

ELIGIBILITY

The adoption credit is available to most adoptive parents, with some exceptions. The credit is not available to taxpayers whose income exceeds certain thresholds. The thresholds are indexed for inflation. In 2017 the credit begins to phase out at $203,540 of modified adjusted gross income and phases out entirely at income of $243,540. The credit also is not available for adoptions of stepchildren.

REFUNDABILITY

The adoption tax credit is nonrefundable but can be carried forward for up to five years. The credit is thus of little or no value to low-income families who pay little or no income tax over a period of years. The Patient Protection and Affordable Care Act of 2010 made the adoption tax credit refundable for 2010 and 2011. Concerned about the potential for fraud, the Internal Revenue Service (IRS) stepped up compliance efforts. The result, according to the National Taxpayer Advocate, was substantial delays for taxpayers, with 69 percent of all adoption credit claims filed in 2012 selected for audit. The IRS ultimately disallowed only 1.5 percent of claims, and 20 percent of those savings were spent on interest owed to taxpayers with delayed refunds. The credit reverted to nonrefundability in 2012.

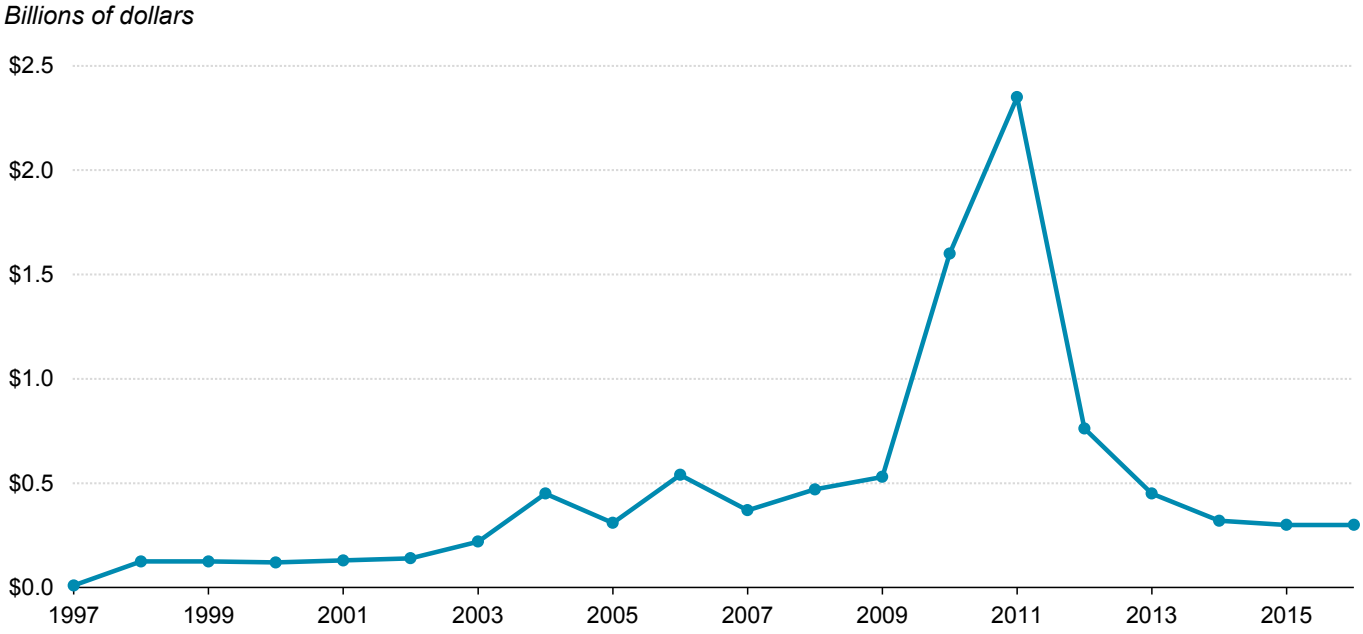
Key Elements of the U.S. Tax System

What is the adoption tax credit?

FIGURE 1

Tax Expenditures for Adoption

Fiscal years 1997–2016



Source: Treasury Tax Expenditure Budget, various years.
Notes: Includes outlay (refundable) portion in years 2010-12. Tax Expenditure estimate includes the value of tax-free employer adoption programs, which are likely 1-2 percent of the total.

TAX EXPENDITURE

The credit has been repeatedly expanded, from an initial maximum value of $5,000 in 1997 to $13,570 in 2017. In fiscal year 2015, credit claims reduced tax liability by $300 million, according to the US Department of Treasury (figure 1). The temporary availability of a refundable credit pushed the tax expenditure up to the dramatically higher figures of $1.6 billion in 2010 and $2.35 billion in 2011 (including the refundable portion).

WHO GETS IT

The distribution of the credit across income groups ranges from small amounts for low- and moderate-income households (because of their minimal tax liability and the credit's non-refundability) and the highest-income households (because of the income cap) to substantial amounts to those with upper-middle incomes. For example, in 2014, the credit for those with incomes between $50,000 and $75,000 (almost 30 percent of claimants) averaged $2,529 per adoption, while the average credit for households with incomes between $100,000 and $200,000 (about 36 percent of claimants) was $8,015 per adoption (table 1).

The most recent year with data available by adoption type (2004) indicates that nearly half of adoptions for which the credit was claimed were for domestic children without special needs, with only 18 percent classified as special needs and the remainder reflecting international adoptions.

What is the adoption tax credit?

TABLE 1

Distribution of Adoption Tax Credit

By total income, 2014

Total income (dollars)	Number of returns with adoption expenses	Total tax benefit (thousands of dollars)	Mean credit (dollars)
Less than 30,000	1,011	718	710
30,000 – under 50,000	10,098	12,327	1,221
50,000 – under 75,000	22,099	55,883	2,529
75,000 – under 100,000	12,973	65,591	5,056
100,000 – under 200,000	26,391	211,520	8,015
200,000 and over	1,379	9,073	6,579
All	73,951	355,110	4,802

Source: IRS, Statistics of Income Division. SOI Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report). Table 3.3

Data Sources

Office of Management and Budget. *Budget of the U.S. Government*, various years, *Analytical Perspectives*. Table 14.1

IRS, Statistics of Income Division. Statistics of Income Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report). Table 3.3

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Taxpayer Advocate Service. 2012. "Most Serious Problems #7: The IRS's Compliance Strategy for the Expanded Adoption Credit Has Significantly and Unnecessarily Harmed Vulnerable Taxpayers, Has Increased Costs for the IRS, and Does Not Bode Well for Future Credit Administration." In *2012 Annual Report to Congress*, volume 1, 111–33. Washington, DC: Taxpayer Advocate Service.

Treasury Inspector General for Tax Administration. 2012. *Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals.* Washington, DC: Department of the Treasury.

Q. What is the earned income tax credit?

A. The earned income tax credit subsidizes low-income working families. The credit equals a fixed percentage of earnings from the first dollar of earnings until the credit reaches its maximum. The maximum credit is paid until earnings reach a specified level, after which it declines with each additional dollar of income until no credit is available.

HOW THE EITC WORKS

The earned income tax credit (EITC) provides substantial support to low- and moderate-income working parents, but very little support to workers without qualifying children (often called childless workers). Workers receive a credit equal to a percentage of their earnings up to a maximum credit. Both the credit rate and maximum credit vary by family size, with larger credits available to families with more children. After the credit reaches its maximum, it remains flat until earnings reach the phaseout point. Thereafter, it declines with each additional dollar of income until no credit is available (figure 1).

By design, the credit only benefits working families. Families with children receive a much larger credit than workers without qualifying children.[1] In 2017, the maximum credit for families with one child is $3,400, while the maximum credit for families with three or more children is $6,318.

In contrast to the substantial credit for workers with children, childless workers can receive a maximum credit of only $510. Moreover, the credit for childless workers phases out at much lower incomes. Also, childless workers must be at least 25 and not older than 64 to qualify for a subsidy—restrictions that do not apply to workers with children. As a result of these tighter rules, 97 percent of benefits from the credit go to families with children.

IMPACT OF THE EITC

Research shows that the EITC encourages single people and primary earners in married couples to work (Dickert, Houser, and Sholz 1995; Eissa and Liebman 1996; Meyer and Rosenbaum 2000, 2001). The credit, however, appears to have little effect on the number of hours they work once employed. Although the EITC phaseout could cause people to reduce their hours (because credits are lost for each additional dollar of eanings, which is effectively a surtax on earnings in the phaseout range), there is little empirical evidence of this happening (Meyer 2002).

The one group of people that may reduce hours of work in response to the EITC incentives are the lower-earning spouses in a married couple (Eissa and Hoynes 2006). On balance, though, the increase in work resulting from the EITC dwarfs the decline in participation among second earners in married couples.

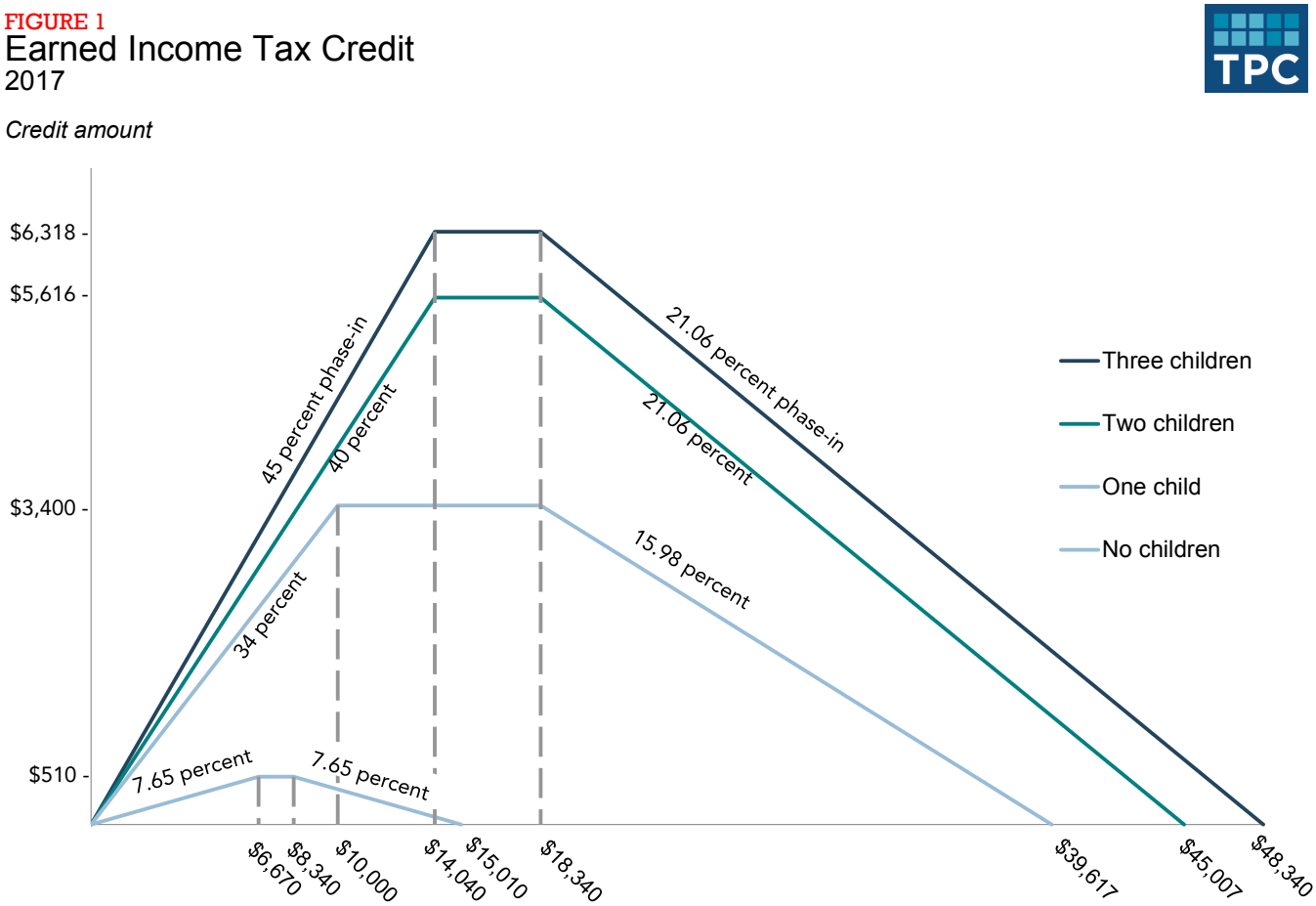
If the EITC were treated like earnings, it would have been the single most effective antipoverty program for working age people, lifting about 6.5 million people out of poverty, including 3.3 million children (CBPP 2016).

Benefits from the EITC are concentrated among the lowest earners, with almost all benefits going to families in the bottom three quintiles of the distribution (figure 2). (Each quinitle contains 20 percent of the population, ranked by household income.)

FIGURE 1

Earned Income Tax Credit

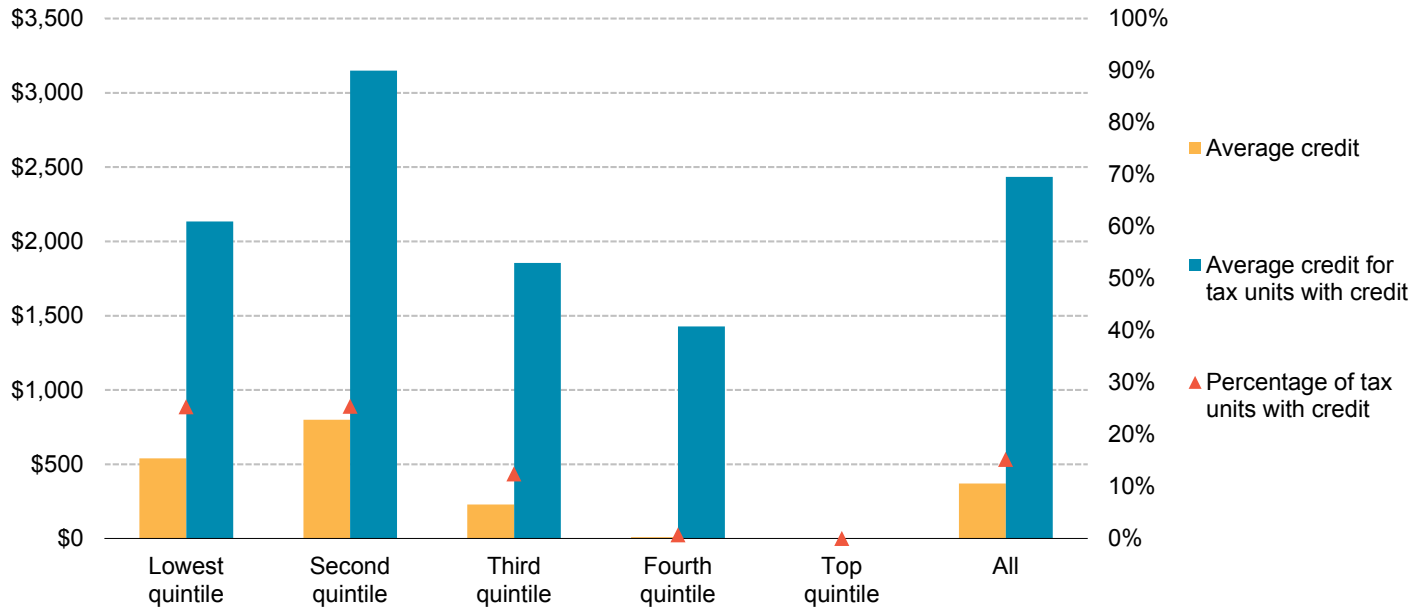
2017



Source: Tax Policy Center, IRS Rev. Proc. 2016-55.
Note: Assumes all income comes from earnings. Amounts are for taxpayers filing a single or head-of-household tax return. For married couples filing a joint tax return, the credit begins to phase out at income $5,590 higher than shown.

FIGURE 2

Distribution of and Percentage of Tax Units with EITC
2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0516-1).

RECENT CHANGES

As a result of legislation enacted in 2001, the EITC phases out at higher income levels for married couples than for single individuals. That threshold was increased as part of the American Recovery and Reinvestment Act of 2009 (ARRA). The same act increased the maximum EITC for workers with at least three children. The American Taxpayer Relief Act of 2012 made the 2001 EITC changes permanent ($3,000 higher threshold for married couple phaseout, indexed) but extended the ARRA changes ($5,000 higher threshold for married couple phaseout, indexed, and higher credit maximum for workers with at least three children) through the end of 2017. The Protecting Americans from Tax Hikes Act of 2015 made these changes permanent.

PROPOSALS FOR REFORM

President Obama and members of the Republican congressional leadership have proposed EITC amendments to provide a substantial credit for childless workers. These proposals typically involve expanding the eligible age limits for the childless EITC—lowering the age of eligibility from 25 to 21 and increasing the age of eligibility from 64 to 67—increasing the maximum credit, and expanding the income range over which the credit is available. A more far-reaching approach to reform that would still expand benefits to childless workers would be to separate the credit into two pieces—one focused on work and one focused on children. Examples of this type of reform have been proposed by many, including the Bush Tax Reform Panel of 2005, the Bipartisan Policy Center, and Maag (2015b).

ERROR RATES AND THE EITC

The EITC likely delivers more than a quarter (28.5 percent) of all payments in error, according to a recent IRS compliance study. The largest source of error was determining whether a child claimed for the EITC actually qualified (Internal Revenue Service 2014). The child must live with the parent (or other relative) claiming the EITC for more than half of the year in order to qualify. The IRS receives no administrative data that can verify where a child resided for the majority of the year, making it difficult for the agency to monitor compliance. Attempts to use administrative data from other programs to verify child residence have not proven successful (Pergamit et al. 2014). In an attempt to reduce fraud, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) requires the IRS to delay tax refunds for taxpayers who claim an earned income tax credit (EITC) or additional child tax credit (ACTC) on their returns until at least February 15.

[1] A qualifying child must meet requirements based on relationship, age, residency, and tax filing status. See: Qualifying Child Rules.

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Q. How does the tax system subsidize child care expenses?

A. Working parents are eligible for two tax benefits to offset child care costs: the child and dependent care tax credit and the exclusion for employer-provided child care.

THE CHILD AND DEPENDENT CARE TAX CREDIT

The child and dependent care tax credit (CDCTC) provides a credit worth between 20 and 35 percent of child care costs up to $3,000 for a child under age 13 or any dependent physically or mentally incapable of self-care. Eligible child care expenses are limited to $6,000 per family. Higher credit rates apply to families with lower adjusted gross incomes (AGIs). Families with incomes below $15,000 qualify for the full 35 percent credit. That rate falls by 1 percentage point for each additional $2,000 of income (or part thereof) until it reaches 20 percent for families with incomes of $43,000 or more. The credit is nonrefundable so it can only be used to offset income taxes owed—in other words, any excess credit beyond taxes owed is forfeited. As a result, low-income families who owe little or no income tax get little benefit from the credit (table 1).

To qualify for the CDCTC, a parent must be working or in school. For married couples, both adults must be working or attending school. In general, allowable expenses are capped at the earnings of the lower-earning spouse. Special rules allow individuals who were students or disabled to have their earned income assumed to be $250 per month ($500 if there is more than one qualifying child).

The Urban-Brooking Tax Policy Center estimates that, in 2016, 12.7 percent of families with children benefited from the CDCTC. Some families with children will not benefit because they do not have child care expenses or, in the case of married couples, only one partner works or goes to school. Among families with children who benefit from the CDCTC, taxes will be reduced by an average of $551. The only income quintile in which families average substantially different benefits is the lowest. (Each quintile contains 20 percent of the population ranked by household income.) Not only are their child care expenses likely to be lower than those of families in higher-income quintiles, they are typically unable to benefit from the credit because the CDCTC is nonrefundable (figure 1).

Key Elements of the U.S. Tax System

How does the tax system subsidize child care expenses?

TABLE 1

Child and Dependent Care Credit
2017

Adjusted gross income (dollars)	Credit rate (percent)	Maximum Credit (dollars)	
		One child	Two or more children
15,000 or less	35	1,050	2,100
15,001–17,000	34	1,020	2,040
17,001–19,000	33	990	1,980
19,001–21,000	32	960	1,920
21,001–23,000	31	930	1,860
23,001–25,000	30	900	1,800
25,001–27,000	29	870	1,740
27,001–29,000	28	840	1,680
29,001–31,000	27	810	1,620
31,001–33,000	26	780	1,560
33,001–35,000	25	750	1,500
35,001–37,000	24	720	1,440
37,001–39,000	23	690	1,380
39,001–41,000	22	660	1,320
41,001–43,000	21	630	1,260
43,000 and over	20	600	1,200

Sources: Internal Revenue Service; Tax Policy Center.

EMPLOYER EXCLUSION: FLEXIBLE SPENDING ACCOUNTS

Employer-provided child and dependent care benefits include amounts paid directly for care, the value of care in a daycare facility provided or sponsored by an employer, and, more commonly, contributions made to a dependent care flexible spending account (FSA).

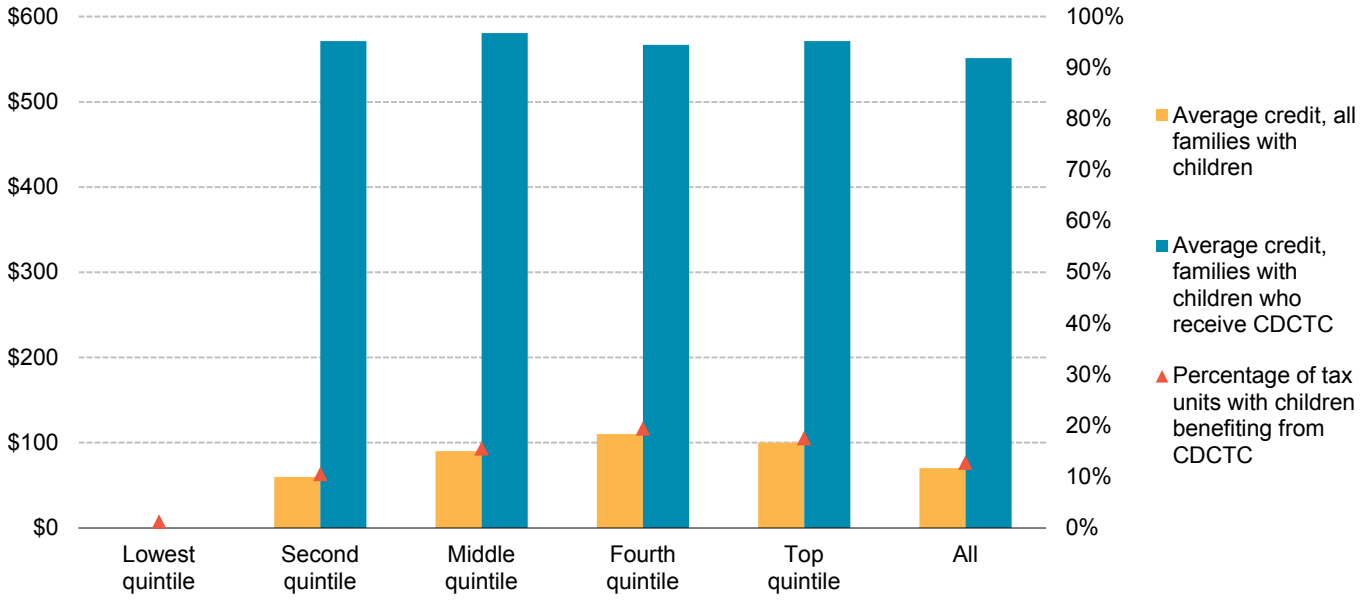
Employees can set aside up to $5,000 per year of their salary (regardless of the number of children) in an FSA to pay child care expenses. (FSAs are also available for health care expenses). The money set aside in an FSA is not subject to income or payroll taxes. Unlike the CDCTC, though, which requires both partners in a married couple to work to claim benefits, only one parent must work to claim a benefit from an FSA. In 2014, 39 percent of civilian workers had access to a dependent care FSA (Bureau of Labor Statistics 2014). Lower earners are less likely to have access to an FSA than higher earners (Stoltzfus 2015).

How does the tax system subsidize child care expenses?

FIGURE 1

Child and Dependent Care Tax Credit for Families with Children, Average Benefits and Participation

2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0516-1).

INTERACTION OF CDCTC AND FSAS

If a family has child care expenses that exceed the amount set aside in a flexible spending account, the family may qualify for a CDCTC. Families first calculate their allowable CDCTC expenses ($3,000 per child under age 13, up to $6,000 per family). If this calculation exceeds the amount of salary set aside in an FSA, a parent may claim a CDCTC based on the difference. For example, a family with two or more children can qualify for up to $6,000 of expenses to apply toward a CDCTC. If that family excluded $5,000 from salaries to pay for child care expenses in an FSA, it may claim the difference between the two ($1,000) for a CDCTC.

Higher-income families generally benefit more from the exclusion than from the credit because the excluded income is free from both income and payroll taxes. Most higher-income families with child care expenses qualify for a credit of 20 percent of their eligible expenses. Because the combined tax saving from each dollar of child care expenses excluded from income exceeds $0.20, the exclusion is worth more than the credit. The exclusion, however, is only available to taxpayers whose employers offer FSAs.

Neither the CDCTC nor the FSA are indexed for inflation. Thus, each year, the real (inflation-adjusted) value of benefits from the two provisions erodes.

How does the tax system subsidize child care expenses?

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Q. What tax benefits exist for K–12 education?

A. While the vast majority of education tax benefits target higher education, two types of federal tax breaks are aimed at K–12 education: tax credit bonds for school construction and reimbursement to teachers for school-supply expenses.

TAX CREDIT BONDS FOR SCHOOL CONSTRUCTION

Created in 1997, the Qualified Zone Academy Bond (QZAB) program provides funds for renovations to existing buildings, equipment, curricula development, and training. The program was expanded in 2009 by the American Recovery and Reinvestment Act (the fiscal stimulus package), which also introduced the Qualified School Construction Bond (QSCB) program. Like the QZAB, the QSCB program funds renovations, but it also supports new construction.

Under these programs, the bonds cost the school or the school district issuing them little or nothing because bond holders are paid in federal tax credits in lieu of interest. In both 2009 and 2010, the QZAB and QSCB programs allocated $1.4 billion and $11 billion, respectively, to fund payments on qualifying bonds. Since 2010, QZAB annual allocations have returned to their initial levels of $400 million annually. The 2010 Hiring Incentives to Restore Employment (HIRE) Act introduced a direct pay option in which the federal government makes payments directly to certain bond issuers under QZAB and QSCB to cover bond interest, rather than providing credits to the bond holders.

Key Elements of the U.S. Tax System

What tax benefits exist for K-12 education?

EDUCATOR EXPENSE DEDUCTION

Teachers can deduct up to $250 annually ($500 for married couples where both spouses are teachers) for unreimbursed expenses on supplies. The deduction covers expenses on books, computer equipment, supplementary materials, and other school supplies and will cost an estimated $210 million in 2017.

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Q. What tax incentives exist to help families save for college?

A. Three tax-favored saving instruments encourage families to save for college: Coverdell savings accounts, qualified tuition programs (commonly known as 529 plans), and the education savings bond program. Because of their characteristics, the first two direct most of the benefit to higher-income families.

Tax-favored accounts encourage families to save for college expenses by reducing or eliminating the tax normally owed. But there's a catch: to reap significant benefits, families must invest in sheltered college savings accounts years before they know whether their children will attend college. While these funds can be redirected toward another person's educational expenses if the child does not go to college, savers must pay penalties to divert the money for other non-education purposes. The resulting uncertainty is greatest for low-income families because their children are least likely to attend college.

Higher-income families benefit more from tax-favored accounts because they avoid more taxes for each dollar contributed to a sheltered account. All families must pay income tax and a 10 percent penalty on money withdrawn from an account if the funds are used for purposes other than permitted educational expenses. However, even after paying the penalties, high-income families can still come out ahead because the accounts let them shift ownership to their children, who typically face lower income tax rates. That benefit, of course, does not extend to low-income families, who are likely to be in the same tax bracket as their children.

COVERDELL ACCOUNTS

In 2017 families with adjusted gross income (AGI) below $110,000 ($220,000 if filing a joint return) can 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. Coverdell account funds can be used for K–12 expenses as well as higher education.

QUALIFIED TUITION PROGRAMS (529 PLANS)

Anyone, regardless of income, may contribute to a 529 plan for a designated beneficiary. A donor may contribute up to $14,000 annually for each beneficiary without triggering a gift tax, with the option of making up to five years of contributions in a single payment so long as no additional gifts are made during the five-year period. Income in 529 plans accumulates untaxed.

What tax incentives exist to help families save for college?

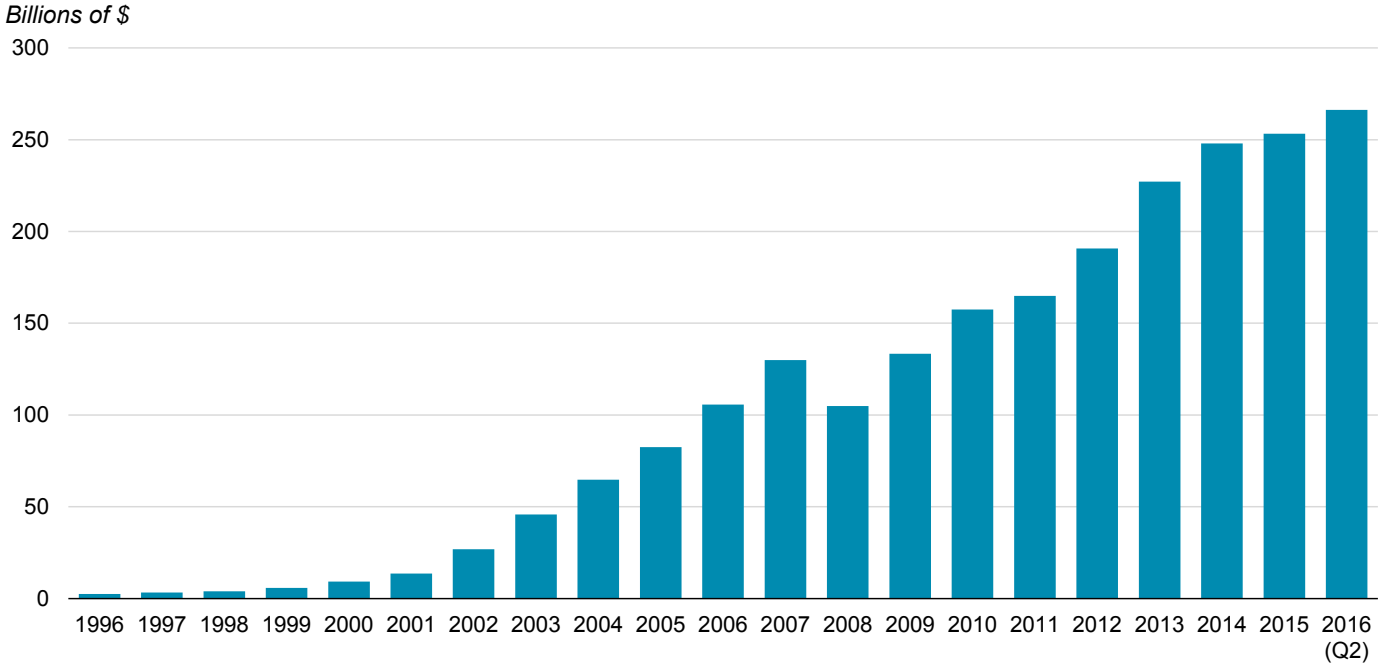
Since passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, funds are not taxed when withdrawn from 529s, provided they are used to pay for postsecondary education. Donors retain ownership of the accounts, but may use the funds to pay educational expenses only for the named beneficiary. The donor may, however, change beneficiaries as long as the new beneficiary is a member of the same family as the old beneficiary.

Assets in 529 plans have grown considerably in the last two decades. In 1996, only 500,000 accounts existed and contained only $2.4 billion. As of June 2016, there were 12.7 million 529 plan accounts containing $266 billion in assets (figure 1).

FIGURE 1

Growth of 529 College Savings Plan Account Assets

1996-2016



Source: College Savings Plan Network, "529 Report," September 2016.

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 plans often receive a state tax break for at least part of their investment. Families can choose to invest in plans from other states, which may be the best option for them—especially when contributions are not tax deductible. A number of states, moreover, provide matching funds for contributions to 529 accounts. Beyond the state plans, there is also a separate private college 529 plan.

Key Elements of the U.S. Tax System

What tax incentives exist to help families save for college?

EDUCATION SAVINGS BOND PROGRAM

The federal government allows buyers to exclude interest on designated government bonds from income tax if the money is used to pay for postsecondary education. In 2017, however, families can only cash in these bonds tax free if their AGI is less than $93,150 ($147,250 if filing a joint return). The income limits are indexed for inflation. This program is substantially smaller than the Coverdell and 529 programs.

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Q. What tax incentives exist to help families pay for college?

A. Rapidly rising college expenses in the 1990s spurred the 1997 enactment of tax incentives for higher education, which currently include the American opportunity tax credit, the lifetime learning credit, and deductions for tuition and fees and for student loan interest.

AMERICAN OPPORTUNITY TAX CREDIT

The American opportunity tax credit (AOTC) provides a credit up to $2,500 per student during the first four years of undergraduate postsecondary school. Students receive a credit of 100 percent against the first $2,000 of tuition, fees, and books, and a 25 percent credit against the next $2,000. Up to $1,000 of the AOTC is refundable; in order to qualify for the credit, students must be enrolled at least half-time for one or more academic periods during the year. AOTC credits, it should be noted, are not indexed for inflation. The AOTC was enacted as part of the fiscal stimulus package and then made permanent in 2015 under the Protecting Americans from Tax Hikes (PATH) Act. The AOTC replaced the Hope credit and is available for more years of schooling (four versus two years), covers more expenses, and is partly refundable.

For 2017 tax returns, the maximum benefit for the AOTC begins to phase out when modified adjusted gross incomes (MAGI) reaches $80,000 and is completed phased out at MAGI of $90,000. For married couples the phaseout range begins at MAGI of $160,000 and the credit is completely phased out at MAGI of $180,000. The phaseout thresholds are not indexed for inflation.

LIFETIME LEARNING CREDIT

The lifetime learning credit (LLC) equals 20 percent of tuition and fees for any postsecondary education expense, up to a maximum annual credit of $2,000 per taxpayer. That maximum applies to the combined expenses of all students in the household claiming the credit and is reached when total qualifying expenses equal $10,000. The maximum benefit for the LLC phases out for MAGI between $56,000 and $66,000 in 2017 (and between $112,000 and $132,000 for married couples). The phaseout thresholds for the lifetime learning credit are adjusted annually for inflation. The LLC is nonrefundable, so only people who owe income tax can benefit.

Key Elements of the U.S. Tax System

What tax incentives exist to help families pay for college?

TUITION AND FEES DEDUCTION

The deduction for tuition and fees allows taxpayers (parents, students, or spouses—whoever pays) to reduce taxable incomes by up to $4,000. To qualify in 2016, a family's modified adjusted gross income may not exceed $65,000 for single, head of household, or qualifying widower filers or $130,000 for married filers. Single, head of household, or qualifying widower filers with AGIs between $65,000 and $80,000 or married filers with AGIs 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. Since the provision is a deduction, it has value only to students and their families with taxable income. The tuition and fees deduction was extended for 2015 and 2016 but is set to expire in 2017 unless extended again.

STUDENT LOAN INTEREST DEDUCTION

The student loan interest deduction allows taxpayers with qualified student loans (loans taken out solely to pay qualified higher education expenses) to reduce taxable income by $2,500 or the interest paid during the year, whichever is less. The loan cannot be from a relative or made under a qualified employer plan, and the student must be a taxpayer, a spouse, or a dependent; only those enrolled at least half-time in a degree program qualify.

Qualified expenses include tuition and fees; room and board; books, supplies and equipment; and other necessary expenses such as transportation. To qualify in 2017, a taxpayer's AGI may not exceed $80,000 for single, head of household, or qualifying widower filers, or $165,000 for married filers. After that, a family is no longer eligible for the deduction. The deduction is, of course, only valuable to people with taxable income. The student loan interest deduction will cost an estimated $1.97 billion in 2017.

HOW THESE TAX INCENTIVES AFFECT STUDENTS

Before Congress created the AOTC, many observers argued that existing tax subsidies had minimal impact on college enrollment because those subsidies went mostly to people who would have attended college even without the additional aid. Many low-income students who might have been the most influenced by reduced college costs received little or no benefit from the Hope and LLC credits because they were nonrefundable and thus could only offset income taxes owed.

In response, the AOTC was made refundable, allowing lower-income families to receive the credit. Even so, students with incomes below $50,000 receive more aid from the Pell grant than from the tax credits. And even with the changes to the tax credits, it remains unclear whether tax credits increase college enrollment (figure 1).

Using the tax system to subsidize higher education has two primary advantages over using traditional spending programs: (1) Students don't have to fill out the daunting Free Application for Federal Student Aid (FAFSA) form to receive benefits; and (2) Every student who qualifies receives the full benefit for which they appear entitled. However, providing aid through the tax system also has disadvantages—notably, the delay in funds being received (up to 15 months after tuition was paid), a lack of transparency about why taxes went down, and potential mismatches in that the person receiving the credit or deduction may not be the student.

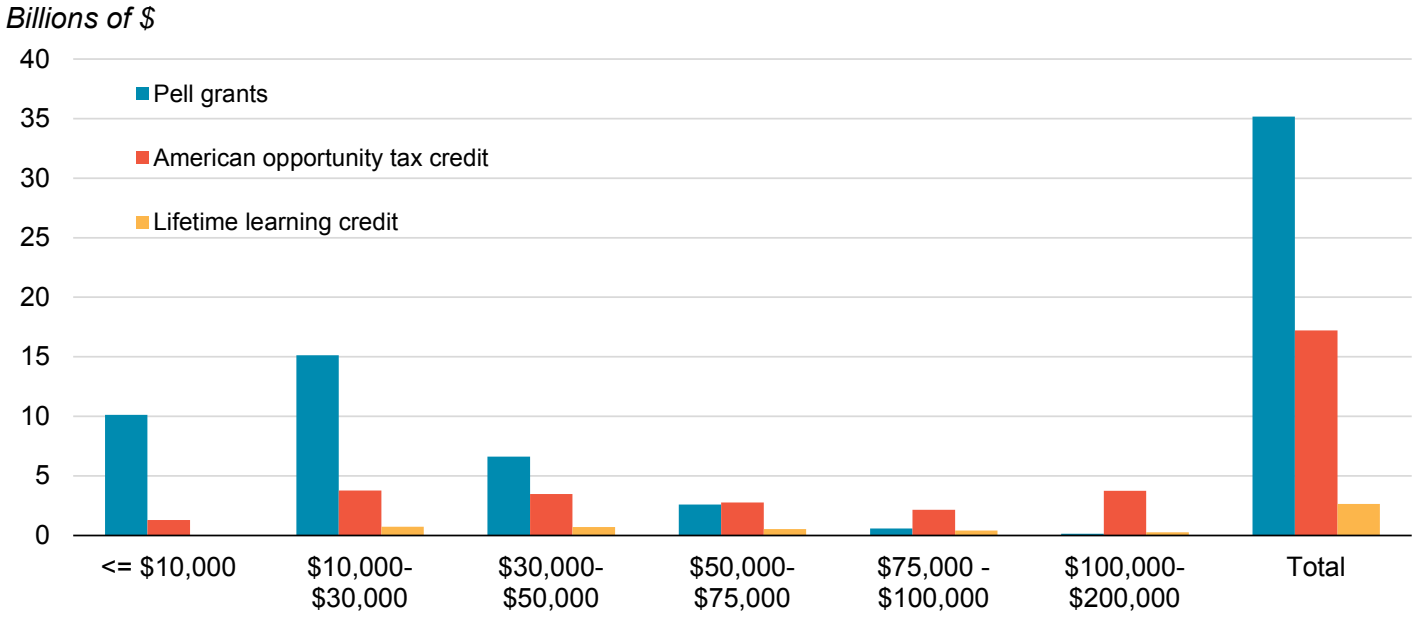
Key Elements of the U.S. Tax System

What tax incentives exist to help families pay for college?

FIGURE 1

Amount of Pell Grants, AOTC, and LLC

All Students, 2017



Source: Tax Policy Center, Table T16-0246, 2016.

OPTIONS FOR REFORM

- Even though some books are eligible expenses under the American opportunity tax credit, additional assistance could be provided by broadening coverage to include other expenses such as room and board.
- Providing benefits directly to schools when students enroll—not months later when their families file tax returns—could help students cover college costs when they are obliged to make payments. Benefit amounts would be based on estimates of the previous year's taxes.
- Consolidating the credits into a single credit would make the process more transparent for students.
- Rather than offering a deduction for student loan interest, providing incentives for students to enroll in income-contingent repayment programs would reduce hardship in student debt repayment.

Key Elements of the U.S. Tax System

What tax incentives exist to help families pay for college?

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Q. What are marriage penalties and bonuses?

A. A couple incurs a marriage penalty if the two pay more income tax filing jointly as a married couple than they would pay if they were single and filed as individuals. Conversely, a couple receives a marriage bonus if they pay less tax filing jointly than they would if they were single.

CAUSES OF MARRIAGE PENALTIES AND BONUSES

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 out with income also produce penalties or bonuses. Couples receiving bonuses greatly outnumber those incurring penalties.

Marriage penalties and bonuses result from the combination of progressive tax rates and taxing married couples as single units. With progressive taxes (which impose higher rates on higher incomes) and tax brackets that are not twice as wide for couples as for individuals, some married couples' income is taxed at higher rates than if each spouse's income was taxed separately. The 10 and 15 percent brackets for joint filers are twice as wide as those for single filers, but the higher rate brackets are less than twice as wide. Note, moreover, that a couple is not obliged to file a joint tax return, but their alternative—filing separate returns as a married couple—almost always results in greater tax liability.

MARRIAGE PENALTIES

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

Consider parents of two children where each parent earns $100,000 and the family has itemized deductions totaling $40,000 (table 1). Filing jointly, their taxable income is $144,000, on which their 2015 income tax liability is $27,588; they would get no child credit because their combined income is too high to qualify. If they could file separately, one as single and the other as the head of a household with two children, the single filer would owe a tax of $14,794 and the head-of-household filer would owe $11,323 minus a child credit of $750, or $10,573, yielding a total tax of $25,366. Their joint tax bill is thus $2,221 higher than the sum of their hypothetical individual tax bills, imposing on them a marriage penalty equal to 1.1 percent of their pretax income.

Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

TABLE 1

Calculation of the Marriage Penalty for a Hypothetical Couple with Two Children

2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$100,000	$100,000	$200,000
Less personal exemptions	$4,000	$12,000	$16,000
Less 20 percent for itemized deductions[b]	$20,000	$20,000	$40,000
Equals taxable income	$76,000	$68,000	$144,000
Of which:			
Taxable at 10 percent	$9,225	$13,150	$18,450
Taxable at 15 percent	$28,225	$37,050	$56,450
Taxable at 25 percent	$38,550	$17,800	$69,100
Taxable at 28 percent	$0	$0	$0
Regular tax liability	$14,794	$11,323	$27,588
Alternative minimum tax	$0	$0	$0
Child tax credit	$0	$750	$0
Tax liability after credits	$14,794	$10,573	$27,588
Final tax liability	**$25,366**		**$27,588**
Marriage penalty (difference in tax liabilities)		**$2,221**	
As share of adjusted gross income		**-1.1%**	

Source: Tax Policy Center calculations.

Note: Detail may not sum to totals because of rounding.

[a] When the couple files separately, spouse one files as single and spouse two as head of household with two children.

[b] Itemized deductions are state and local taxes (10 percent of AGI), mortgage interest (5 percent of AGI), and charitable contributions (5 percent of AGI).

MARRIAGE BONUSES

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.

Consider a couple with two children and $200,000 in total earnings, all earned by spouse two (table 2). Under 2015 tax law, they will receive a marriage bonus of more than $9,000 as a result of three factors. First, filing jointly, the couple can claim $16,000 in personal exemptions, a third again what they could claim if spouse two filed a head-of-household return claiming two children and spouse one filed a single return—with no earnings, spouse one could not claim an exemption. Second, because tax brackets for joint returns (other than the 10 percent and 15 percent brackets) are wider than those for head-of-household returns, much of the couple's income is taxed at lower rates under joint filing than the 28 percent marginal rate the spouse two would pay filing separately. Finally, spouse two would fall under the alternative minimum tax (AMT) filing separately, boosting taxes by an additional $4,942. In combination, the three factors yield a marriage bonus of $9,229, or 4.6 percent of their adjusted gross income. More than half of that bonus would result from the difference in AMT liability.

Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

TABLE 3

Calculation of the Marriage Bonus for a Hypothetical Couple with Two Children

2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$0	$200,000	$200,000
Less personal exemptions	$4,000	$12,000	$16,000
Less 20 percent for itemized deductions[b]	$0	$40,000	$40,000
Equals taxable income	$0	$148,000	$144,000
Of which:			
Taxable at 10 percent	$0	$13,150	$18,450
Taxable at 15 percent	$0	$37,050	$56,450
Taxable at 25 percent	$0	$79,400	$69,100
Taxable at 28 percent	$0	$18,400	$0
Regular tax liability	$0	$31,875	$27,588
Alternative minimum tax	$0	$4,942	$0
Child tax credit	$0	$0	$0
Tax liability after credits	$0	$36,817	$27,588
Final tax liability	**$36,817**		**$27,588**
Marriage bonus (difference in tax liabilities)		**$9,229**	
As share of adjusted gross income		**4.6%**	

Source: Tax Policy Center calculations.

Note: Detail may not sum to totals because of rounding.

(a) When the couple files separately, spouse one files as single and spouse two as head of household with two children.

(b) Itemized deductions are state and local taxes (10 percent of AGI), mortgage interest (5 percent of AGI), and charitable contributions (5 percent of AGI).

EFFECT OF RECENT TAX CUTS ON MARRIAGE PENALTIES

Before the 2001 tax act, married couples were already significantly more likely to receive bonuses than to pay penalties. The Congressional Budget Office (1997) 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. That year, Congress raised the standard deduction for couples to twice that for single filers and set the income ranges for couples in the 10 and 15 percent tax brackets to twice the corresponding ranges for individuals. The 2001 tax act temporarily raised the starting point of the earned income tax credit (EITC) phaseout range for married couples by $3,000 above that for single filers. The 2009 American Recovery and Reinvestment Tax Act temporarily boosted the increase to $5,000 and indexed it for inflation, and the American Taxpayer Relief Act of 2012 extended that increase through 2017. Before the increase expired, however, the Protecting Americans from Tax Hikes Act of 2015 made the $5,000 increase for married couples permanent.

Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

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; therefore, combining income for joint filing can lead to higher tax rates. In fact, the 35 percent bracket in 2015 starts at the same income level for single and joint filers and heads of household, and thus 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. Because that is less than twice the single filer's threshold, it can impose marriage penalties on some taxpayers. Finally, AMT parameters for couples are less than twice those for unmarried individuals. For example, the 2015 AMT exemption for joint filers is $83,400, less than twice the $53,600 exemption for single filers.

MARRIAGE PENALTIES AND THE EARNED INCOME TAX CREDIT

Taxpayers who might qualify for the EITC can suffer particularly large marriage penalties if the income of one spouse disqualifies the couple. However, marriage can increase the EITC if a nonworking parent files jointly with a low-earning worker.

TABLE 3

Calculation of the Marriage Penalty for a Low-Income Hypothetical Couple with Two Children

2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$20,000	$20,000	$40,000
Less personal exemptions	$4,000	$12,000	$16,000
Less standard deduction	$6,300	$9,250	$12,600
Equals taxable income	$9,700	$0	$11,400
Of which:			
Taxable at 10 percent	$9,225	$0	$11,400
Taxable at 15 percent	$475	$0	$0
Regular tax liability	$994	$0	$1,140
Alternative minimum tax	$0	$0	$0
Child tax credit	$0	$2,000	$2,000
Earned income tax credit (EITC)	$0	$5,150	$2,100
Tax liability after credits	$994	-$7,150	-$2,960
Couple's final tax liability	**-$6,156**		**-$2,960**
Marriage penalty (difference in tax liabilities)		**$3,196**	
As share of adjusted gross income		**8.0%**	

Source: Tax Policy Center calculations.

Note: Detail may not sum to totals because of rounding.

(a) When the couple files separately, spouse one files as single and spouse two as head of household with two children.

What are marriage penalties and bonuses?

Consider a couple with two children and $40,000 in total earnings, split evenly between husband and wife (table 3). Two factors will cause them to incur a marriage penalty of more than $3,000 under 2015 tax law. First, if they were not married, the wife could file as head of household with two children and the husband would file as single. Filing In that way, their combined standard deductions would be $15,550, $2,950 more than the $12,600 standard deduction available on a joint return (although that is offset by their losing $1,250 of their combined deductions because the wife's deduction cannot reduce her taxable income below zero). At the couple's marginal tax rate of 10 percent, those effects increase their tax liability by $170 (10 percent of $1,700). Second—and more significant—filing separate returns, the wife could claim an earned income tax credit (EITC) of $5,150 and a $2,000 child credit; the husband would get neither tax credit. On net, the wife would receive a payment of $7,250 and the husband would pay $994, yielding a joint tax refund of $6,156. Filing jointly, the couple will get a smaller EITC of $2,100 plus the $2,000 child tax credit. Thus, filing jointly, the couple will receive a payment of $2,960, $3,196 less than the $6,156 they would have gotten if they could have filed separately; the $3,196 difference equals 8.0 percent of their adjusted gross income.

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. Moreover, the interaction of a tax penalty and a program eligibility penalty can create effective marginal tax rates that approach 100 percent.

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Q. How does the federal tax system affect low-income households?

A. Most low-income households do not pay federal income taxes, typically because their incomes are lower than the combination of their allowed standard deduction and their personal and dependent exemptions, or because they receive substantial rebates via refundable tax credits. However, nearly all low-income workers are subject to the payroll tax.

WHAT FEDERAL TAXES DO LOW-INCOME HOUSEHOLDS PAY?

Low-income households typically pay some federal tax. The Tax Policy Center estimates that, on average in 2017, households in the lowest income quintile (the bottom fifth) will owe federal taxes equal to 3.7 percent of their incomes, much lower than the average 20.1 percent tax rate for all households.

But the income tax is not the reason these households owe federal taxes. In fact, TPC estimates that in 2017, households in the lowest income quintile have a negative average income tax rate thanks to refundable credits—namely the earned income tax credit (EITC) and the child tax credit (CTC). That is, the payments they receive from refundable credits exceed any income tax they owe.

In contrast, the average payroll tax rate for households in the lowest income quintile is 6.1 percent (very similar to the average rate of 6.9 percent for all households). The payroll tax is by far the most significant federal tax for households in the lowest income quintile, in terms of how much they pay.

Of course, low-income households pay federal excise taxes on their purchase of specific products, including cigarettes, alcohol, and gasoline. Low-income households also indirectly pay some corporate income tax, to the extent that corporations pass tax burdens back to workers' wages.

WHAT SHARE OF LOW-INCOME HOUSEHOLDS OWE FEDERAL INCOME OR PAYROLL TAX?

Only 12.1 percent of households in the bottom income quintile will pay federal income tax in 2017. In contrast, 57.4 percent of households in the lowest income quintile will owe payroll taxes. Combined, 58.7 percent of households in the lowest income quintile will owe federal income or payroll taxes.

Key Elements of the U.S. Tax System

How does the federal tax system affect low-income households?

In many cases, low-income households owe no income tax. That's because they can deduct a standard deduction and personal exemptions from their taxable income. In 2017, a married couple with two children will be able to exempt $28,900 from income using the standard deduction ($12,700) and personal exemptions ($4,050 per person).

WHY DO LOW-INCOME HOUSEHOLDS FACE NEGATIVE AVERAGE FEDERAL INCOME TAX RATES?

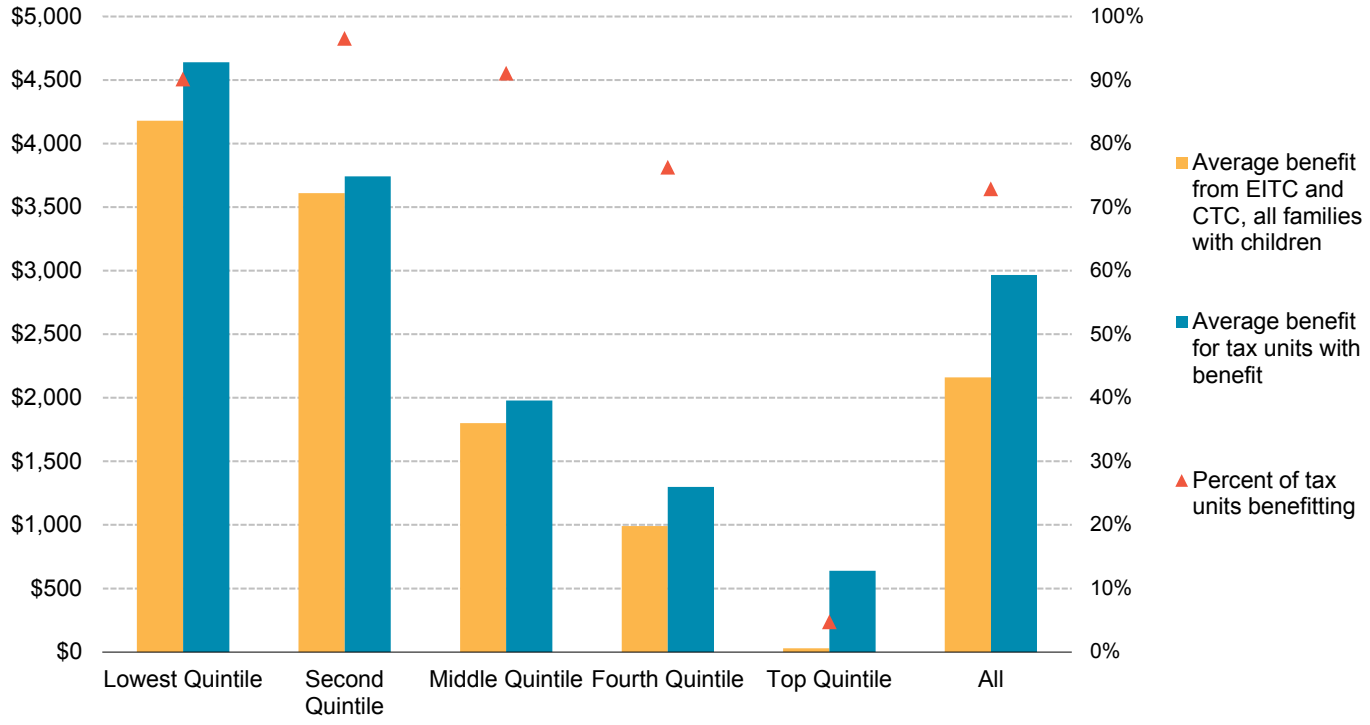
The EITC is a refundable credit that subsidizes earnings, particularly for workers with children. The CTC is partially refundable, providing up to $1,000 per child under age 17 for workers with children. Together, these credits deliver substantial assistance to low-income families with children. (A relatively small EITC is also available to childless workers.) The net refunds created by these credits show up as negative average tax rates.

Together, the Tax Policy Center estimates that in 2017, the CTC and the EITC will provide tax-filing parents in the lowest income quintile an average refund of around $4,600. The credits will benefit 90.1 percent of these households (figure 1).

FIGURE 1

Average Benefits and Participation in the Earned Income Tax Credit and Child Tax Credit

2017



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Key Elements of the U.S. Tax System

How does the federal tax system affect low-income households?

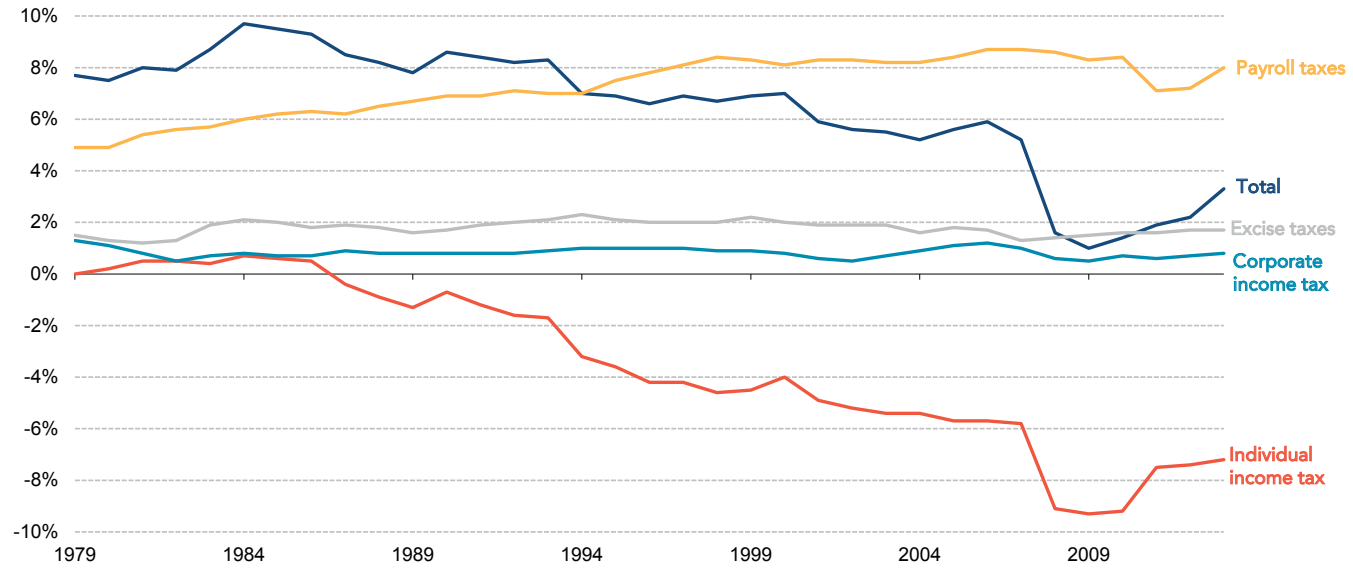
HOW HAVE EFFECTIVE TAX RATES FOR LOW-INCOME HOUSEHOLDS CHANGED OVER TIME?

Average tax rates for low-income households have changed markedly over the past quarter-century (see figure 2). Creation of the CTC and expansion of the EITC both lowered the effective individual income tax rate for these households from about 0.5 percent in the early 1980s to its negative value today. In contrast, the effective payroll tax rate for households in the lowest income quintile increased by more than half over the same period (setting aside the temporary payroll tax reduction in 2011 and 2012). The effective corporate income tax rate borne by low-income households has also fallen since 1979, while the effective excise tax rate rose slightly.

FIGURE 2

Average Federal Tax Rates for Households in the Lowest Income Quintile

1979-2013



Source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes 2013," June 2016.

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Q. What is the difference between refundable and nonrefundable credits?

A. Taxpayers subtract both refundable and nonrefundable credits from the taxes they owe. If a refundable credit exceeds the amount of taxes owed, the difference is paid as a refund. If a nonrefundable credit exceeds the amount of taxes owed, the excess is lost.

REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

The maximum value of a nonrefundable income tax credit is capped at a taxpayer's income tax liability. In contrast, taxpayers receive the full value of their refundable tax credits. The amount of a refundable tax credit that exceeds tax liability is refunded to taxpayers.

Most tax credits are nonrefundable. Notable exceptions include the fully refundable earned income tax credit (EITC), the premium tax credit for health insurance (PTC), the refundable portion of the child tax credit (CTC) known as the additional child tax credit (ACTC), and the partially refundable American Opportunity Tax Credit (AOTC) for higher education. With the EITC, PTC, and ACTC, taxpayers calculate the value of these credits and receive the credit first as an offset to taxes owed, with any remainder paid out as a refund.

BUDGET TREATMENT OF REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

The federal budget distinguishes between the portion of a tax credit that offsets tax liability and the portion that is refundable, classifying the latter as an outlay. Most of the EITC—an estimated $63.1 billion of the FY 2016 total of $65.4 billion—will be refunded. Much less of the child tax credit ($27.0 billion out of $51.3 billion) will be refunded. (figure 1).

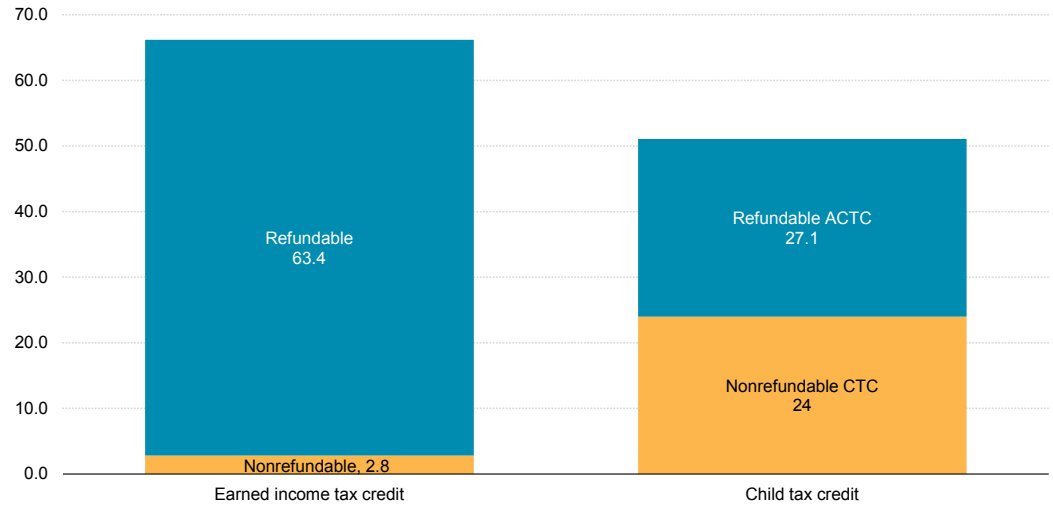
Key Elements of the U.S. Tax System

What is the difference between refundable and nonrefundable credits?

FIGURE 1

Refundable and Nonrefundable Shares of EITC and the Child Tax Credit

Billions of dollars, FY 2016



Source: Office of Management and Budget. "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2017: Tax Expenditures," Table 14–1.

ADVANTAGES AND DISADVANTAGES OF REFUNDABLE CREDITS

Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. This is especially true for the EITC and the CTC: if the credits were not refundable, low-income households most in need of assistance would not benefit from them. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.

Opponents of refundable credits, for their part, raise a host of objections:

- The tax system should collect taxes, not redistribute income.
- The government should not use the tax system to carry out social policies.
- Everyone should pay some tax as a responsibility of citizenship,
- Refundable credits increase administrative and compliance costs, and encourage fraud.

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Q. Can poor families benefit from the child tax credit?

A. The child tax credit (CTC) provides a credit of up to $1,000 per child under age 17. If the CTC exceeds taxes owed, families are eligible to receive all or part of the balance as a refund, known as the additional child tax credit (ACTC) or refundable CTC. The credit is reduced by 5 percent of adjusted gross income over $75,000 for single parents and over $110,000 for married couples.

HOW THE CTC WORKS

Taxpayers can claim a child tax credit of up to $1,000 per child under age 17. The credit is reduced by 5 percent of adjusted gross income over $75,000 for single parents ($110,000 for married couples). 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 $3,000.

Families at nearly all income levels benefit from the CTC – with the largest average benefits (about $1,500) going to families with children in the second and third income quintiles. Families in the highest income quintile receive the smallest average benefits because the credit phases out for workers once adjusted gross income reaches $75,000 (single parents) or $110,000 (married parents).

Neither the credit amount nor the phaseout point is indexed for inflation. Over time, the value of the credit will decline and as incomes grow, more people will be subject to the credit's phase out.

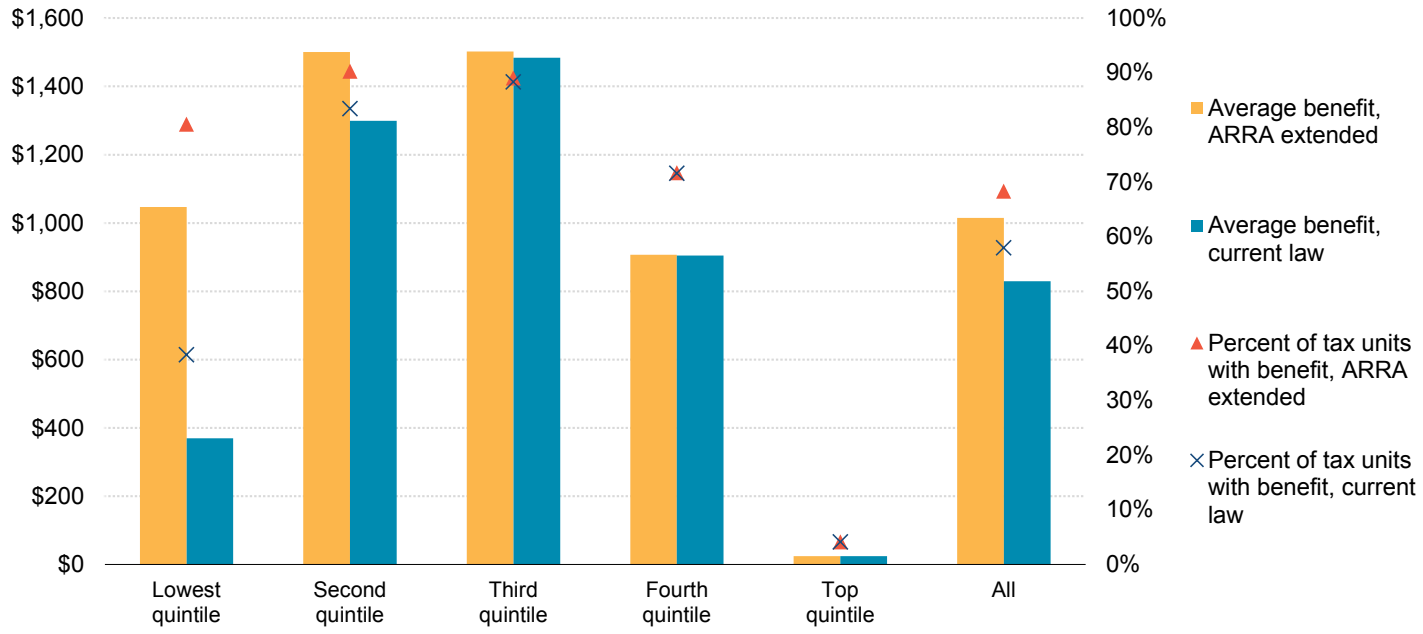
Key Elements of the U.S. Tax System

Can poor families benefit from the child tax credit?

FIGURE 1

Average CTC Benefit for Families with Children under Current Law and with $3,000 Refundability Threshold Extended

2018



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0515-1).

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Q. Why do low-income families use tax preparers?

A. Many low-income families owe no income tax but still must file a tax return to receive refundable tax credits, including the earned income tax credit (EITC). Those who do file often need help, which nearly always comes from a paid preparer. The cost of that help erodes the net value of the EITC and other refundable credits. That cost might be worth bearing if preparers helped their clients claim tax benefits that otherwise might be missed, but many don't.

TAX PREPARATION FOR LOW-INCOME FAMILIES

Most people fill out their tax returns with assistance from paid preparers. In 2010, 56.8 percent of all returns were completed this way. That proportion is slightly lower for lower-income families, 54.5 percent for returns with adjusted gross incomes below $30,000 (table 1). A very small proportion of low-income families reported using Volunteer Income Tax Assistance (VITA) clinics.

TABLE 1

Tax Preparation Method

By adjusted gross income, 2010

AGI (thousands of dollars)	Tax returns (millions)	Tax Preparation Method				
		No identified preparer	Paid preparer	IRS-prepared	Volunteer-income tax assistance	Tax counseling for the elderly
Under 30	65.7	41.8%	54.5%	0.2%	1.7%	1.7%
30–50	25.6	42.3%	55.7%	0.1%	0.9%	1.0%
50–100	30.7	40.9%	58.2%	0.0%	0.4%	0.5%
Over 100	18.2	36.6%	63.2%	0.0%	0.1%	0.1%
Total	142.8	40.9%	56.8%	0.1%	1.0%	1.1%

Source: Tax Policy Center tabulations of 2010 Statistics of Income Public Use File.

Why do low-income families use tax preparers?

DO PAID PREPARERS FILL OUT MORE ACCURATE RETURNS?

Except in a handful of states, paid preparers are not regulated. The Government Accountability Office (GAO) found that returns completed by preparers were not more accurate than self-prepared returns and included errors in calculating a tax filer's EITC – a problem specific to low- and moderate-income families.

In a small sampling performed by the GAO, only 2 of 19 returns showed the correct refund amount. On 13 tax returns in the sample, preparers overestimated the total refund by $100 or more (GAO 2014). A larger-scale study of IRS data showed that paid preparers had a higher estimated error rate—60 percent—than returns prepared by taxpayers themselves. Some of these errors are made by the preparer; some are the result of the taxpayer providing incorrect or incomplete information (GAO 2014).

These latter results were not limited to low-income families' returns. When it comes to returns with the EITC, a recent study showed that unenrolled return preparers were more likely to make errors than other paid preparers. An unenrolled return preparer is someone other than an attorney, CPA, or an enrolled agent—agents licensed by the IRS. Unenrolled preparers completed 43 percent of the EITC returns made by paid preparers, while national tax preparation firms completed 35 percent of these returns (Internal Revenue Service 2014).

One clear benefit of paid preparation: an earlier study of low-income workers showed that if someone already knows about the EITC, they are more likely to receive it if they use a paid preparer to manage the paperwork than if they fill out their returns themselves (Maag 2005). Moreover, some preparers not only inform their low-income clients of their EITC eligibility, but further help them by identifying other forms of assistance for which they might qualify, and some even assist in the application process.

USE OF REFUND ANTICIPATION LOANS AND REFUND ANTICIPATION CHECKS

Prior to 2012, low-income tax filers who used paid preparers could get their tax refunds faster with a refund anticipation loan (RAL). RALs were relatively high-cost immediate cash loans from private lenders, backed by the tax refunds the borrowers claimed on their prepared returns (Theodos 2011). RALs proliferated after 1999 when the IRS reinstituted the debt indicator program, which disclosed whether a tax refund would be redirected by the Internal Revenue Service to pay debts.

The IRS has since discontinued use of the debt indicator, essentially eliminating the RAL market. However, most consumers who formerly received a RAL now appear to be using a similar product, the refund anticipation check (RAC). The RAC appears to cost less than the RAL but it can still be quite expensive. RACs are temporary bank accounts opened by paid preparers, where tax filers direct their refunds. Tax filers are allowed to pay fees out of their RACs. When the IRS deposits the refund, the paid preparer subtracts fees from the account, and then the tax filer can access the remainder.

In 2014, the National Consumer Law Center reported that more than 21 million consumers obtained RACs. Unlike RALs, RACs do not allow consumers faster access to anticipated refunds (Wu 2015). The vast majority of RAC consumers—about 83 percent—have low incomes. In fact, about half are EITC recipients (Wu 2015).

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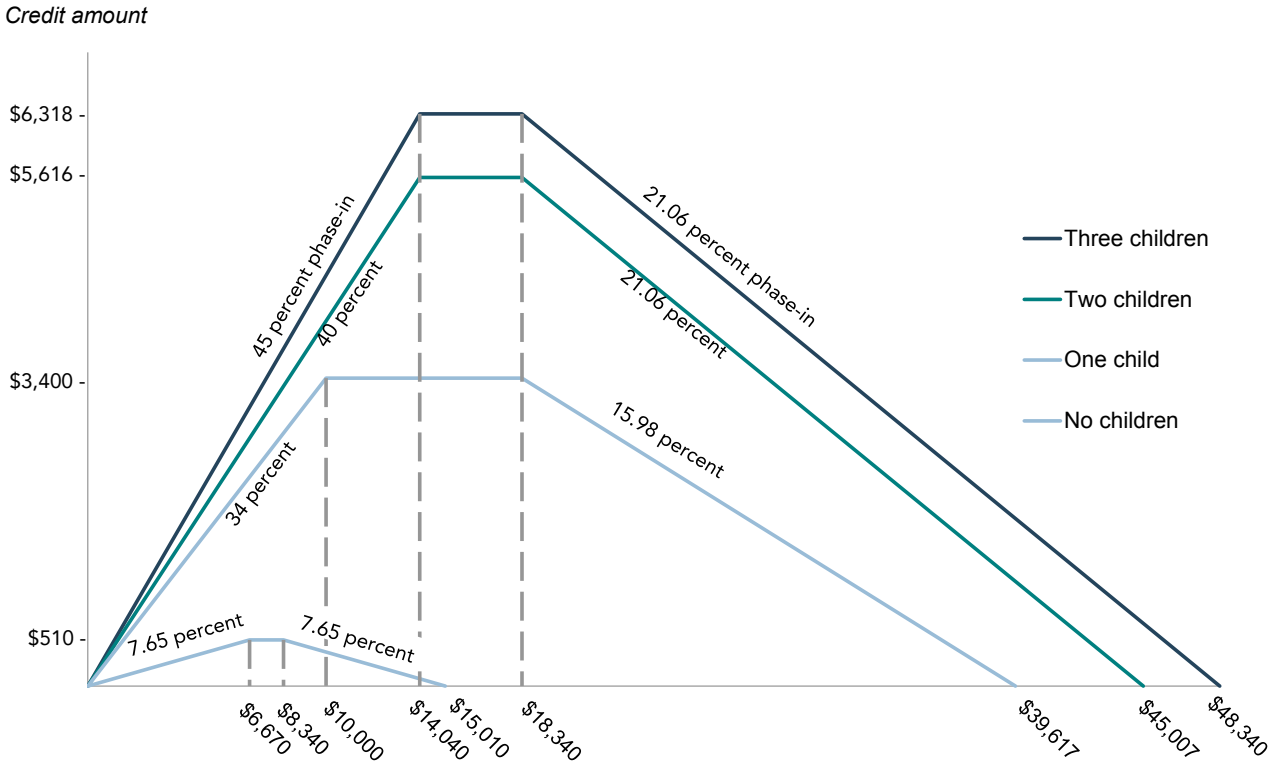
Q. How does the EITC affect poor families?

A. The EITC is the single most effective federal antipoverty program for working age households — providing additional income and boosting employment for low-income workers.

In 2017, the earned income tax credit (EITC) will provide credits ranging from $510 for workers with no children to $6,318 for workers with at least three children (figure 1).

FIGURE 1
Earned Income Tax Credit
2017



Source: Tax Policy Center, IRS Rev. Proc. 2016-55.
Note: Assumes all income comes from earnings. Amounts are for taxpayers filing a single or head-of-household tax return. For married couples filing a joint tax return, the credit begins to phase out at income $5,590 higher than shown.

Key Elements of the U.S. Tax System

How does the EITC affect poor families?

POVERTY AND THE EITC

Official estimates of poverty compare the before-tax cash income of families of various sizes and compositions with a set of thresholds. Many social transfer programs use the poverty thresholds to determine program eligibility. The official poverty measure excludes the effect of federal tax and noncash transfer programs on resources available to the family. Thus, although the EITC adds income to poor households, it does not change the official number of those living in poverty.

To understand how the social safety net changes resources, the US Census Bureau has developed a supplemental poverty measure (SPM) that includes additional resources available to families (and additional expenses) not captured in the official measure (Renwick and Fox 2016). To determine how well off a family is, the SPM compares resources available to resources needed, taking into account regional differences.

Resources needed include not only basic items such as food and housing, but also taxes and expenses such as those associated with work and health care. Resources available include government transfers, including noncash transfers, and refundable tax credits such as the EITC. Official Census publications show that together, the child tax credit (CTC) and the EITC lifted 9.2 million people out of poverty in 2015 (Renwick and Fox 2016). The Center on Budget and Policy Priorities separates the effects of the EITC and the CTC and calculates that the EITC was responsible for lifting 6.5 million people out of poverty (CBPP 2016). This makes the EITC the single most effective program targeted at reducing poverty for working-age households.

REDUCING POVERTY BY ENCOURAGING WORK

Substantial research confirms that the EITC encourages single people and primary earners in married couples to work (Dickert, Houser, and Sholz 1995; Eissa and Liebman 1996; Meyer and Rosenbaum 2000, 2001). The credit, however, appears to have little effect on the number of hours people work once they are employed. Although the EITC phaseout could cause people to reduce their work hours (because credits are lost for each additional dollar of earnings, effectively a surtax on earnings in the phaseout range), there is little evidence that this actually happens. (Meyer 2002).

The most recent relevant study found that a $1,000 increase in the EITC led to a 7.3 percentage point increase in employment and a 9.4 percentage point reduction in the share of families with aftertax and transfer income in poverty (Hoynes and Patel 2015). If this employment effect were included in census estimates of poverty reduction (rather than just the dollars transferred through the credit), the number of people lifted out of poverty would be much greater.

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Q. What are error rates for refundable credits and what causes them?

A. The IRS estimates two types of error rates for the earned income tax credit (EITC): the improper payment rate and the over-claim rate. The former includes IRS enforcement activities while the latter does not. The IRS has estimated an EITC improper payment rate of between 22 and 26 percent of EITC payments and an over-claim rate of between 28 and 39 of claims.

IMPROPER PAYMENTS IN THE EITC

Extrapolating from the IRS's National Research Program compliance study of individual income tax returns for tax year 2009, the Treasury Department projected that in fiscal year 2013 between 22.1 percent and 25.9 percent of total EITC program payments were improper (US Department of the Treasury 2013). The Office of Management and Budget identified the earned income tax credit (EITC) as having the highest improper payment rate and the second-highest improper payment amount among 13 "high-error" programs.

Errors can stem from intentional fraud or innocent mistakes made by taxpayers—the latter, a likely result of complex rules associated with the EITC. Studies by Treasury analysts indicate that only a minority of improper payments stem from fraudulent actions (Holtzblatt and McCubbin 2002).

The estimated 22.1–25.9 percent range is likely higher than the actual error rate. A 2004 study by the Taxpayer Advocate found that, in 2002, among 67,000 people who sought reconsideration of their audit results, 43 percent were owed the entire or almost entire EITC claim that had initially been denied.

EITC OVER-CLAIMS

A more recent IRS study of returns claiming the EITC found that from 2006 to 2008, between 28.5 and 39.1 percent of all EITC claims represented over-claims totaling between $14.0 billion and $19.3 billion (IRS 2014). The largest source was error in classifying children as "qualified." Roughly 75 percent of all tax returns with qualifying-child errors violated the requirement that children live with the taxpayer in the United States for more than six months of the year (IRS 2014).

IRS RESPONSE

The IRS is combating improper payments by implementing due diligence requirements for paid preparers (IRS 2015). The IRS has tried to strengthen paid-preparer regulation before, but the courts ruled in 2012 that the agency had overstepped its authority and would not be allowed to require competency tests of some preparers (Taxpayer Advocate 2013).

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Q. How do IRS audits affect low-income families?

A. The IRS audits a disproportionate (but still small) share of tax returns that include EITC claims. The agency has found that average discrepancies between taxes owed and taxes paid are smaller on EITC returns than on all returns.

IRS AUDITS OF EITC RETURNS

In FY 2015, the IRS audited 1.4 million of the almost 192 million returns filed, less than 1 percent of the total. Returns claiming an EITC were audited at a rate more than twice that of all individual income tax returns: 1.7 percent compared with 0.8 percent. Almost all these audits (92 percent) were correspondence audits, meaning the tax filer was no-tified and could respond by mail.

For all individual income tax returns audited in FY 2015, the IRS recommended higher taxes on 89 percent. For EITC returns, the agency recommended higher taxes on a slightly higher 91 percent. The average amount of money the IRS attempted to collect on all audited returns was $10,022. The average amount on audited EITC returns was $4,917. The IRS recommended additional refunds on 3.2 percent of all individual income tax returns versus 1.2 percent of EITC returns. The average recommended refund on all returns was $27 compared to $5 for EITC returns.

Data Sources

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Q. What kind of tax-favored retirement accounts are there?

A. Tax-favored retirement accounts can be sliced and diced in various ways. There are three big differences, though: who sponsors them, who bears the risk, and when Uncle Sam takes his cut.

Defined-benefit plans generally distribute funds on a regular basis during retirement according to formulas that account for employees' years of work and earnings. In defined-contribution plans, of which the 401(k) plan is the most common, balances depend on the size of past employee and employer contributions and on the investment returns accumulated on those contributions.

Accounts established by individuals include two types of individual retirement accounts (IRAs): traditional IRAs and Roth IRAs. Like 401(k)s, traditional IRAs allow taxpayers to deduct their contributions, up to a preset limit, from taxable income. Tax liability is only triggered when funds are distributed to the account owners. By contrast, contributions to Roth IRAs and Roth 401(k)s yield no tax breaks when they are made, but distributions to retirees, including accumulated investment income, are tax-free.

Employers are not required to offer retirement benefits to their employees, and only about half of all workers receive them. Employees of large companies are more likely to receive employer-sponsored retirement benefits than their counterparts in small firms. In 2015, about two-thirds of workers at medium-size and large firms received retirement benefits, compared with about one-third of workers at small firms. In 2015, almost all government employees (89 percent) received retirement benefits of one sort or another.

Participation in retirement accounts initiated by individuals rather than employers is less common. In 2013, only around 14 percent of households contributed to any type of IRA.

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Q. How large are the tax expenditures for retirement savings?

A. The expenditures are very large, indeed. They topped $158 billion in 2015 and will likely exceed $1 trillion over the 2015–19 period.

Tax expenditures are revenue losses attributable to special exclusions, exemptions, deductions, credits, and other provisions in the tax code. Congress's Joint Committee on Taxation (JCT) calculates the tax expenditure for retirement savings as the sum of the revenue loss due to the tax-exclusion for current-year contributions and earnings on account balances, minus the revenue from taxation of current-year pension and IRA distributions (table 1).

TABLE 1

Tax Expenditures for Retirement Savings

Billions of dollars, 2015–19

Plan type	2015	2015-19
Pension plans	**129.4**	**881.5**
Defined benefit plans	48.6	315.6
Defined contribution plans	72.8	504.8
Keogh plans	8.0	61.1
Individual retirement plans	**28.0**	**116.7**
Traditional IRAs	20.9	77.2
Roth IRAs	7.1	39.5
Credit for elective deferrals and contributions	**1.2**	**6.0**
Total expenditures	**158.6**	**1,004.2**

Source: Joint Committee on Taxation, 2015.

The White House Office of Management and Budget (OMB) publishes tax expenditure estimates calculated in a similar fashion by the Treasury's Office of Tax Analysis (OTA). OMB also publishes alternative estimates that take into account the deferral of tax payments on pension and IRA contributions and earnings. That calculation is the sum of the immediate revenue loss due to retirement savings contributions, plus the "present value" of revenue loss that occurs as a result of the tax exemption for accrued earnings on that contribution in future years, minus the present value of the revenue due upon future withdrawals (table 2).

Key Elements of the U.S. Tax System

How large are the tax expenditures for retirement savings?

TABLE 2

Present Value of Tax Expenditures for Retirement Savings

Billions of dollars, 2015

Plan type	2015
Employer plans	**97.1**
Defined benefit plans	25.0
Defined contribution plans	67.2
Self-employed plans	5.0
Individual retirement plans	**6.5**
IRA contributions and earnings	1.4
Roth earnings and distributions	4.7
Non-deductible IRA earnings	0.4

Source: Office of Management and Budget (2016).

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Q. What are defined-benefit retirement plans?

A. Lifetime annuities promised by employers and, in most cases, partially guaranteed by the federal government.

RISKS

In contrast to other types of retirement accounts, the risk in a defined-benefit plan is borne mostly by the employer. If retired employees live longer than anticipated, or if the investments financing the employees' pensions fail to meet expectations, it is the employer's responsibility to increase contributions to make good on the promised benefits. Defined-benefit plans are thus more likely to be offered by large employers, who are better suited to bear the risk and to spread fixed administrative costs across larger numbers of participants.

However, not all the risk falls on employers. Defined-benefit plans are insured by the Pension Benefit Guarantee Corporation, a federal entity which ensures that retired employees receive at least some of their benefits if their employers are unable to pay the promised sums in full.

TRENDS

Defined-benefit plans have been falling in popularity (at least among employers) over the past few decades. From 1991 to 2003, the share of full-time employees at medium-size and large establishments with defined-benefit plans fell from 59 percent to 33 percent. Over the next 12 years, that share fell to just 25 percent. Defined-benefit plans, however, are still the most common type of plan for government employees.

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Q. Who uses tax-favored retirement savings accounts?

A. Almost all workers are eligible, but only half take advantage of them.

TABLE 1

Participation in Tax-Favored Retirement Plans

Percentage of eligible workers participating by type of plan, 2006

	Any plan	IRAs	401(k) type plans	Non-contributionary plans
Age				
Under 30	33	4	16	15
30-44	57	7	34	20
45-59	64	10	39	19
60 and over	45	9	23	15
All ages	52	7	29	18
Income ($2006 in thousands)				
Under 20	17	2	5	11
20-40	47	5	23	21
40-80	65	9	38	22
80-120	77	12	50	21
120-160	81	15	58	17
160 and over	81	11	56	14
All incomes	52	7	29	18
Marital status of earner				
Unmarried	41	5	22	16
Married				
Sole	52	8	30	17
Primary	74	10	48	20
Secondary	57	10	31	20
All earners	52	7	29	18

Source: Congressional Budget Office, "Use of Tax Incentives for Retirement Saving in 2006," CBO Background Paper (Washington, October 2011).

Key Elements of the U.S. Tax System

Who uses tax-favored retirement savings accounts?

Participation in tax-favored retirement savings accounts varies dramatically with age (Table 1). In recent years, about one-third of workers under age 30 participated, compared with almost two-thirds of workers ages 45 to 59. By the same token, participation varies with earnings (Table 1). About four in five high-income workers participate, but slightly fewer than one in five low-income workers participate.

401(K) CONTRIBUTIONS

In recent years, the participation rate of higher-income workers in 401(k)-type plans was more than twice that of lower-income workers. Among workers who participated, contributions were highly correlated with income. The average contribution in 2006 was $4,352. But workers earning over $160,000 contributed more than twice the mean ($11,004) and those earning $20,000 to $40,000 averaged just $1,288.

INDIVIDUAL RETIREMENT ACCOUNT CONTRIBUTIONS

Participation rates in traditional IRAs increase with income. The relationship between participation and income is less straightforward for Roth IRAs because eligibility is limited to those with adjusted gross incomes under $193,000 (for married workers in 2015).

IRA contribution limits are more restrictive than those for 401(k)s. Partly as a result of these restrictions, average contributions vary less than for 401(k)-type plans. In 2006, the average contribution to an IRA was $2,718. Those with incomes in the $20,000 to $40,000 range contributed an average of $2,587, while those earning more than $160,000 averaged $3,920. As workers approach retirement, the average contribution increases. There is little difference in contribution levels to IRAs for married and unmarried workers.

Among those with traditional IRAs, 52 percent maxed out their contributions in 2006, with a significantly higher proportion of high-income taxpayers hitting the limit. Among those with Roth IRAs, 39 percent contributed the maximum amount—again, with higher-income taxpayers doing so more frequently. This pattern illustrates one reason why proposals to increase the maximum tax-favored IRA contribution would disproportionately benefit the affluent.

Data Sources

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Q. What are defined-contribution retirement plans?

A. Think savings accounts with tax benefits—and a lot of rules.

Tax-deferred defined-contribution plans include 403(b) plans for nonprofit employees, 457 plans, mostly for state and local government employees, and the more familiar 401(k) plans.

TRENDS

The share of employees with defined-contribution plans has slowly increased over the last 25 years. From 1991 to 2003, participation of full-time employees at medium-size and large enterprises rose from 48 percent to 51 percent; in 2015 that figure reached 56 percent. All told, about half of all workers have defined-contribution accounts. However, within the defined-contribution plan universe, participation in savings type plans has grown at the expense of profit-sharing plans, which benefit from employer contributions.

RISKS

Defined-benefit plans offer employees a contractually assured annuity at retirement; in contrast, owners of defined-contribution plans bear the risk of underperforming assets and the possibility of outliving the income generated. This risk can be managed if employees use the assets in their plans to purchase annuities from insurance companies at retirement.

CONTRIBUTIONS AND WITHDRAWALS

Contributions to defined-contribution plans are tax-deferred, meaning that neither the employer nor the employee pays tax on the initial contributions or accumulating plan earnings. However, employees pay when they withdraw funds. The major exception is Roth-type defined-contribution plans. With these plans, taxes are due on contributions when they are made rather than when the contributions are withdrawn.

Withdrawals from defined-contribution accounts incur penalties (above regular income tax), except for specified purposes ranging from financial hardship to higher education to the first purchase of a home.

What are defined-contribution retirement plans?

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Q. What types of nonemployer-sponsored retirement savings accounts are available?

A. The two big types are traditional individual retirement accounts (IRAs) and Roth IRAs. The main difference: when the feds take their cut.

TRADITIONAL IRAS VERSUS ROTH IRAS

Workers and their spouses do not need their employers' help to save in tax-favored retirement accounts. Individual retirement accounts mostly come in two forms: traditional IRAs and Roth IRAs. (Other types of IRAs, such as IRA-SEPs and SIMPLE-IRAs, are only available through employers.) The primary difference 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 are taxed. Contributions to Roth IRAs, conversely, are taxed in the year they are made. But account assets are allowed to grow tax-free, and withdrawals during retirement years are not taxed. Even though the statutory contribution limits are the same for both types of accounts, the effective amount that a saver can place in tax-preferred status is higher with a Roth IRA because the contribution is made with post-tax income.

As of 2015, 40.2 million households (or 32 percent) owned at least one IRA. Some 30.4 million households (or 24.4 percent) held traditional IRAs, while 20.3 million owned a Roth IRA. Some households owned both.

THE FINE PRINT

These rules are a bit confusing. Taxpayers with income greater than a specified level, which varies with tax filing status, may not contribute to a Roth IRA and may not deduct contributions to a traditional IRA. Nor may taxpayers who participate (or whose spouses participate) in employer-provided pensions deduct traditional IRA contributions if their income exceeds a specified limit.

For single taxpayers without access to an employer-sponsored pension, and for married couples in which neither spouse participates in such a pension plan, 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 spouse does, may contribute the maximum statutory amount to an IRA, provided the couple's joint income does not exceed $186,000.

Key Elements of the U.S. Tax System

What types of nonemployer-sponsored retirement savings accounts are available?

Further Reading

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Q. What are Roth individual retirement accounts?

A. Roth individual retirement accounts (IRAs) offer no up-front tax breaks. However, withdrawals of earnings as well as principal (with some restrictions) are not taxed.

OVERVIEW

A Roth IRA is a form of an individual retirement account in which contributions are made with after-tax earnings. Eligibility is limited by income. There's still a big tax break: contributions are allowed to accrue tax-free in the account, and withdrawals are not taxed under normal circumstances. In 2015, 20.3 million people, representing 16.3 percent of all US households, owned a Roth IRA.

ELIGIBILITY AND CONTRIBUTION LIMITS

Only people with incomes under specified limits are eligible to contribute to a Roth IRA. In 2017, the contribution limit for IRAs is the lesser of $5,500 ($6,500 for individuals over age 50) or the taxpayer's taxable compensation. The contribution limit falls once household income exceeds certain thresholds and eventually reaches zero (table 1).

TABLE 1
Eligibility and Contribution Limits
2017

Filing status	Modfied Adjusted Gross Income	Contribution
Single or Head of Household	Less than $118,000	$5,500 (or $6,500 if over 50)
	Between $118,000 and $133,000	A reduced amount
	$133,000 and over	Zero
Married filing jointly or qualifying widow(er)	Less than $186,000	$5,500 (or $6,500 if over 50)
	Between $186,000 and $196,000	A reduced amount
	$196,000 and over	Zero
Married filing separately	Zero	$5,500 (or $6,500 if over 50)
	Between zero and $10,000	A reduced amount
	$10,000 and over	Zero

WITHDRAWALS

Investors are allowed to withdraw their contributions (but not investment returns earned on those contributions) at any time without being subject to tax. However, to receive tax benefits on investment returns, withdrawals must be qualified distributions, meaning that funds were withdrawn 5 years after the first contribution was made and after the contributor reaches age 59 years and 6 months, dies, becomes disabled, or makes a qualified first-time home purchase. Nonqualified distributions do not satisfy the above conditions and are therefore taxed and subject to a 10 percent penalty tax. There are several exceptions to the penalty for the early withdrawal of investment earnings.

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How does tax-favored retirement saving affect national saving?

Q. How does the availability of tax-favored retirement saving affect national saving?

A. It only increases private saving if the tax breaks encourage households to set aside additional cash rather than simply transferring it from other nest eggs. It only increases national saving if the increase in private saving exceeds the revenue loss from the tax subsidy.

Tax-favored retirement savings accounts are popular: half of working adults take advantage of them. It's unclear, however, whether they make much difference to overall savings and retirement preparedness. Although traditional pensions and other tax-deferred vehicles such as 401(k) plans and individual retirement accounts (IRAs) do make up a sizable share of households' wealth, the accounts only increase private saving if they encourage households to finance their own contributions through reductions in consumption or increases in earnings.

Put another way, incentives do not increase private saving if households finance their contributions by borrowing, by shifting their existing assets into tax-favored accounts, or by shifting current saving that would have occurred even in the absence of the incentive. Likewise, there is no increase in private saving if households respond to employer-provided pensions or contributions with equivalent reductions in other saving or with increased borrowing.

The earliest research on both traditional defined-benefit pensions and defined-contribution plans suggested that they had a very strong impact on private wealth and saving. These studies, however, were marred by technical missteps, and later research has found a significantly smaller impact—and, in some cases, none at all.

To the extent that the tax incentives do raise saving, the impact can be expected to be greater for lower- and middle-income households than for high-income households, who tend to use the accounts as a means to reduce present or future tax liability.

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Q. What's the difference between front-loaded and back-loaded retirement accounts?

A. Your choice: pay the IRS now or pay them later.

Broadly speaking, there are two types of tax-favored retirement accounts: "front-loaded" accounts, such as traditional IRAs and 401(k)s, and "back-loaded" accounts, such as Roth IRAs. With front-loaded accounts, contributions are tax-deductible but withdrawals are taxed. These accounts are also called EET accounts (the contribution is *exempt* from taxation, the accrual of returns is *exempt* from taxation, the withdrawal is *taxed*). In back-loaded accounts, contributions are not tax-deductible but accruals and withdrawals are tax-free. These accounts are also called TEE accounts (contributions *taxed*, accruals *exempt*, withdrawals *exempt*). In both types of accounts, investment returns on assets kept within the account (accruals) are untaxed.

Which is a better deal? That depends on the difference between individuals' tax rates during their working years and during retirement. Individuals with high tax rates during their working years and lower rates during retirement benefit more from front-loaded accounts, since the original contributions are deducted against high tax rates and withdrawals are taxed at lower rates. Someone who expects to be in a higher bracket in retirement would benefit more from a back-loaded account.

The example in Table 1 shows that if tax rates during working years and retirement are the same, front- and back-loaded accounts yield the same result.

Consider a front-loaded account first. Say an individual faces a 25 percent tax rate when making both contributions and withdrawals, makes a before-tax contribution of $2,000, earns 5 percent per year, and withdraws all funds after 10 years. In a front-loaded account, the individual will be able to contribute the full $2,000. The account will accumulate interest, and after 10 years the balance will be $3258. Upon withdrawal, the individual will pay $814 in taxes, leaving net retirement assets of $2,443. With a back-loaded account, an individual pays a 25 percent tax on $2,000 in income, leaving $1,500 to contribute to the account. With the same 5 percent return, the balance will grow to $2,443. Since no taxes will be paid on withdrawal, after-tax proceeds are $2,443, which is the same as in the front-loaded example.

What's the difference between front-loaded and back-loaded retirement accounts?

TABLE 1

Front and Back Loaded Savings Accounts with Constant Tax Rate

$2015

Plan overview		
Tax rate: 0.25		
Interest: 0.05		
Time (years): 10		
	Front loaded	Back loaded
Before tax income	2,000	2,000
Less: taxes paid (25%)	0	500
Contribution	2,000	1,500
Accumulated balance in account	3,258	2,443
Less: taxes paid on withdrawal (20%)	814	0
After-tax proceeds	2,443	2,443

Now check out the example in Table 2, the tax rate decreases from 25 percent during working years to 20 percent during retirement. Here, the front-loaded account will accrue $163 more than the back-loaded account, since taxes are imposed upon withdrawal, when rates are lower. Of course, the conclusion is reversed if the tax rate is higher during retirement than during working years.

TABLE 2

Front and Back Loaded Accounts with Lower Tax Rate at Retirement

$2015

Plan overview		
Tax rate T0: 0.25		
Tax rate T10: 0.20		
Interest: 0.05		
Time (years): 10		
	Front loaded	Back loaded
Before tax income	2,000	2,000
Less: taxes paid (25%)	0	500
Contribution	2,000	1,500
Accumulated balance in account	3,258	2,443
Less: taxes paid on withdrawal (20%)	652	0
After-tax proceeds	2,606	2,443
Tax savings from front loaded account: 163		

That's not quite the end of the story, though. If the two accounts have the same contribution limit, an individual can shelter more savings in a back-loaded account than in a front-loaded account. For example, if an individual facing a 25 percent marginal income tax rate contributes $2,000 to a front-loaded account, he or she is really contributing $1,500 and $500 of government funds because of the tax deduction. When the funds are withdrawn, the government reclaims its share of the principal contribution, plus taxes on interest earned (table 3). In a back-loaded account, however, taxes are paid on the initial contribution and interest can be withdrawn tax-free. Note the distinction here. The value of the tax shelter per dollar saved is the same with either account. However, if the nominal contribution limits are identical, a determined saver can sock away more with a back-loaded account.

TABLE 3

Tax Savings in Front and Back Loaded Savings Accounts with Constant Tax Rate

$2015

Plan overview		
Tax rate: 0.25		
Interest: 0.05		
Time (years): 10		
	Front loaded	Back loaded
Contribution	2,000	2,000
Own income	-1,500	-2,000
Government tax expenditure	-500	0
Accumulated balance in account	3,258	3,258
Taxes paid on withdrawal	814	0
After-tax proceeds	2,443	3,258
Additional savings with back loaded account: 814		

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Q. What is an automatic 401(k)?

A. An Automatic 401(k) enrolls workers automatically, assigning them a default contribution rate and allocation of funds that they are free to change later.

An automatic 401(k) is one that automatically enrolls workers in the plan, rather than requiring them to sign up. Eligible workers are assigned a default contribution rate—often 3 percent of wages—and a default allocation of funds contributed to the retirement account. As with traditional 401(k)s, workers are still in control; they can change the default contribution rate and allocation or opt out entirely. The main difference: with an automatic 401(k), inaction on the worker's part will automatically result in the worker saving for retirement.

This difference is, as a practical matter, significant. With traditional 401(k) plans, workers must decide 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 are difficult, and many workers, daunted by the complexity, either make inappropriate choices or never sign up at all.

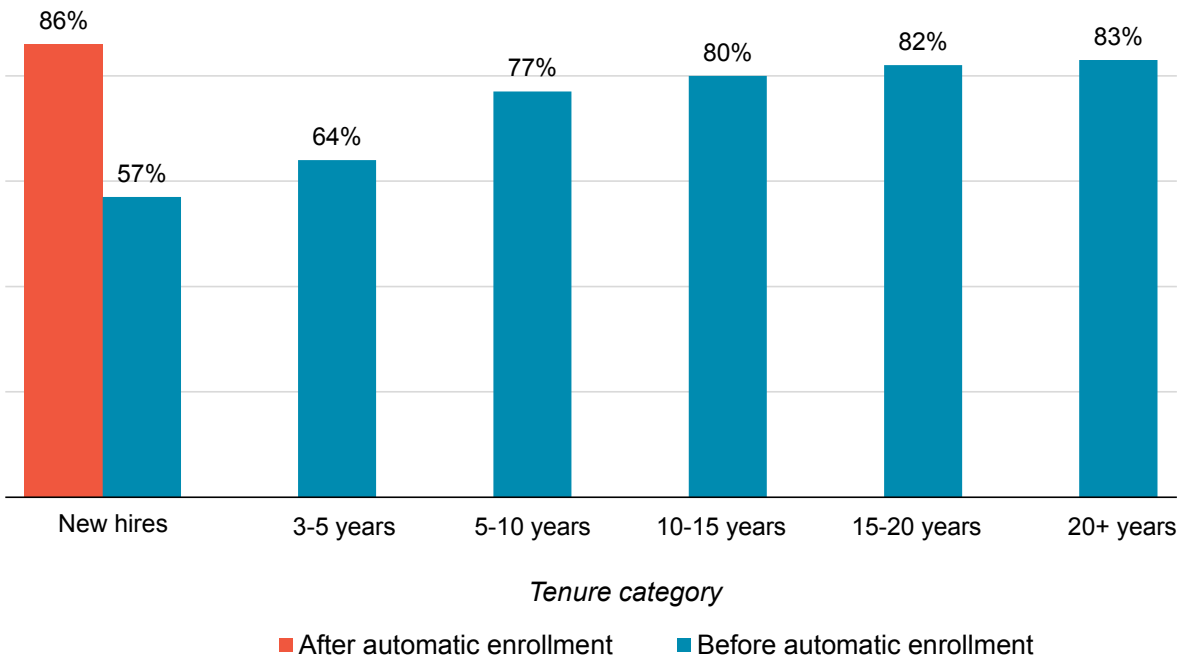
With an automatic 401(k), sometimes called an "opt-out plan," unless workers make the active decision not to participate, each stage of the savings and investment allocation process is automatically set at a pro-saving default. Workers can choose to override any of these choices, but the inertia that discourages so many from opting in to a traditional 401(k) is now likely to keep them on the default path.

Figure 1 shows that automatic enrollment raises 401(k) participation rates among new hires. This is especially true for women, minority groups, and low earners.

The automatic escalation of default contributions over time raises overall contributions to 401(k)s relatively painlessly as employees become accustomed to deferring the receipt of a portion of their pay. The gradual escalation also helps ensure that inertia does not keep employees at a default contribution rate lower than the rate they might have chosen without the default.

FIGURE 1

Participation Rates in 401(k) by Tenure: Pre- and Post-auto 401(k)



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Q. How might low- and middle-income households be encouraged to save?

A. Expanding access to savings vehicles and scaling back deductions to provide greater incentives to low- and middle-income households could make a difference.

Low- and middle-income families receive significant income support through tax breaks, notably through refundable credits such as the earned income tax credit and the child tax credit. When it comes to building wealth, however, the tax code's more than $400 billion in subsidies—incentives for everything from homeownership to health insurance to higher education—go mainly to high-income households.

Roughly 70 percent of the mortgage interest deduction and deductions for state and local property taxes, along with about two-thirds of subsidies for employer-based and individual retirement accounts, go to the top 20 percent of earners. That's because these tax subsidies are structured as deductions and exclusions, which provide bigger subsidies to households in higher tax brackets. Further, lower-income households are less likely to have enough deductions to make it worthwhile to itemize on their tax returns, and itemization is required for claiming major homeownership tax breaks. Lower-income workers, particularly those in part-time or temporary employment, have less access and are less likely to participate in employer-based retirement plans.

At the same time, many low- and middle-income taxpayers simply do not participate in the regular and automatic saving vehicles through which much wealth accumulation occurs, such as paying off a mortgage and making regular deposits to retirement accounts.

A variety of changes would reduce the bias toward higher-income households by replacing existing subsidies with better-targeted incentives. Almost all these proposals favor some movement toward tax credits and scaling back deductions, and many use insights from behavioral economics to get more bang for a tax buck forgone.

Key Elements of the U.S. Tax System

How might low- and middle-income households be encouraged to save?

HOMEOWNERSHIP

Credits to encourage homeownership can take different forms. They can provide an up-front credit for first-time homebuyers of primary residences, similar to a temporary credit employed as a stimulus measure from 2008 to 2009. (An early version of this credit served as an interest-free loan to be paid back to the IRS.) Alternatively, homeowners could receive smaller annual credits proportional to their home equity, up to a designated maximum. Another approach is to provide a credit against property taxes paid on a home to defray a significant cost of homeownership. Reforms that reward building equity instead of subsidizing mortgage interest (which a badly designed credit could also do) would encourage actual saving instead of the acquisition of debt.

RETIREMENT

A saver's credit is available to moderate-income taxpayers who contribute to qualified retirement plans. However, the credit is nonrefundable and phases out quickly at higher levels of income, making few people eligible for the maximum amount. Some economists have proposed expanding the credit and making it refundable, so that workers with no net income tax liability could claim it. More expansive proposals include reshaping the complicated pension landscape to simplify plans and increase access to employer-based retirement accounts with automatic enrollment. Contribution limits to tax-favored accounts would be lowered, and low- and moderate-income workers would instead receive government matches on their contributions. Any credits or matching employer contributions could not be accessed until retirement. Pension antidiscrimination rules could be revised to favor plans that support a larger percentage of full- and part-time employees.

ENCOURAGE SAVINGS AND ACCOUNT OWNERSHIP AT TAX TIME

Many low- and middle-income workers receive large refunds at tax time from refundable tax credits. A "saver's bonus" could be offered to encourage taxpayers to save a portion of their refunds in qualified savings accounts. Taxpayers are already able to contribute to individual retirement accounts until the tax filing deadline and apply any deductions or saver's credits against their tax year's liability. Some tax preparers and tax preparation software remind taxpayers that they are able to do this and make clear how much tax they can save if they do. Tax time could also be used to link taxpayers to savings vehicles, such as children's savings accounts or prepaid cards with savings features for taxpayers without bank accounts.

How might low- and middle-income households be encouraged to save?

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Q. What is the myRA?

A. The myRA is a Roth-structure retirement savings account targeted at low-income households and those without access to an employer-sponsored plan.

Launched in December 2014 by executive order, the myRA program is a savings plan offered by the US Treasury that's intended to encourage retirement saving among low-income individuals lacking employer-sponsored accounts or other convenient saving options. As of March 2016, 10,000 people opened a myRA account, with a median monthly contribution of $50. MyRAs have a Roth IRA structure and follow more or less the same rules as private-sector Roth IRAs. The sole investment available is a new Treasury security that earns the same interest rate as the government bond fund available to federal employees.

After accounts reach a maximum balance of $15,000 or have been in existence for 30 years, savings must be rolled over to a Roth IRA in the private sector. Currently, the only way for an individual to contribute funds to a myRA account is to establish a direct-deposit system with an employer. MyRAs do not have start-up fees or account maintenance fees.

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Q. How are charitable contributions treated?

A. Corporations and individual taxpayers who itemize can deduct charitable contributions to 501(c)(3) organizations.

Many 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 after taxes.

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. An important caveat: Only taxpayers who choose to itemize may take the charitable deduction; taxpayers who instead claim a standard deduction generally get more deductions that if they itemize but, as a result, get no additional incentive for contributions to charity.
In 1935, Congress extended the right to deduct charitable contributions to corporations. Corporations may not deduct more than 10 percent of their pretax income in a given year, but, like individuals, may carry forward excess donations for five years. Some corporate contributions, however, might also qualify as business expenses.

Contributions by individuals or corporations can take the form of cash, financial assets, or other noncash property such as real estate, clothing, or artwork. Certain contributions face greater restrictions than cash contributions, whereas others receive more generous treatment than cash. The limit for donations of appreciated real property is generally 30 percent of AGI, and the limit for contributions to private nonoperating 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.

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Q. What entities are tax-exempt as charitable activities?

A. Nonprofit organizations that do not distribute profits can be exempt from federal income tax if organized expressly for public purposes.

Although many nonprofits qualify for tax exemption, only about two-thirds also qualify to receive contributions that donors can deduct on their tax returns. These are organi-zations for "charitable purpose," defined under section 501(c)(3) of the tax code as "re-ligious, 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 organizations are created to distribute funds to charities or indi-viduals.
Tax-exempt organizations (including charities) include many diverse entities. The Na-tional Taxonomy of Exempt Entities—developed by the National Center of Charitable Statistics at the Urban Institute and used by the Internal Revenue Service (IRS)—classifies into 9 major groups, 26 categories, and over 600 subcategories.

The major groups are as follows:

1. Arts, culture, and humanities (e.g., art museums, historical societies)
2. Education (e.g., private schools, universities, parent-teacher associations)
3. Environment and animals (e.g., humane societies, the Chesapeake Bay Founda-tion)
4. Health (e.g., nonprofit hospitals, the American Lung Association)
5. Human services (e.g., the Girl Scouts, the YMCA, food banks, homeless shelters)
6. International and foreign affairs (e.g., CARE, the Asia Society, the International Committee of the Red Cross)
7. Public society benefit (e.g., the Rockefeller Foundation, the Urban Institute, civil rights groups, the United Way)
8. Religion-related (e.g., interfaith coalitions, religious societies)
9. Mutual membership or benefit (e.g., nonprofit credit unions, labor unions, fra-ternal organizations)

In 2013, approximately 1.41 million tax-exempt organizations were registered with the IRS. These nonprofits accounted for approximately 5.4 percent of U.S. gross domestic product and paid 9 percent of U.S. wages and salaries (as of 2014). About 35 percent of registered nonprofits are required to file annual returns (Form 990, 990-EZ, or 990-PF); organizations with gross receipts between $25,000 and $50,000 must file a simpler in-formation return known as the 990-N (e-postcard). Religious congregations, as well as organizations with less than $25,000 in gross receipts are exempted from the annual filing requirement. All private foundations are required to file the 990-PF.

Key Elements of the U.S. Tax System

What entities are tax-exempt as charitable activities?

Tax-exempt status confers multiple benefits. Not only are nonprofits exempt from federal tax on earnings from their income-producing assets and activities (other than those that generate unrelated business income), but charities also sometimes qualify to issue tax-exempt bonds and are often exempt from state and local property taxes and sales taxes.

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Q. Who benefits from charitable deductions?

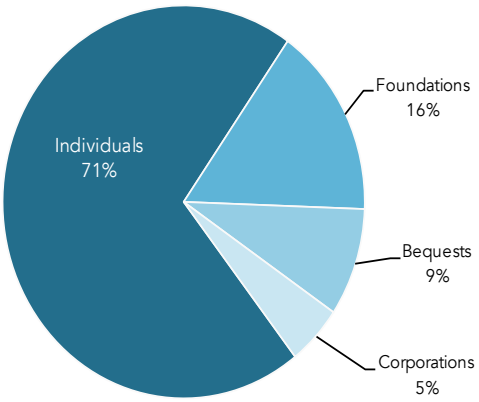
A. The charitable deduction subsidizes charitable giving by lowering the net cost to the donor.

A charitable contribution is intended for the benefit of those supported by the charitable activity, whether through education, health care, or the like. If the tax deduction spurs additional giving, charitable organizations may be able to provide more services. Do-nors are assisted in their efforts by the charitable deduction, which reduces their own tax liability.

FIGURE 1

Sources of Charitable Giving

2015



Source: Giving USA Foundation. 2016. Giving USA 2016: *The Annual Report on Philanthropy for the year 2016*. Indianapolis, IN: Giving USA Foundation.

Key Elements of the U.S. Tax System

Who benefits from the charitable deductions?

The charitable deduction subsidizes donors by lowering the net cost of the gift. Just how much the tax deductibility lowers the cost of giving depends on the donor's mar-ginal tax rate. For instance, a donor in the 30 percent tax bracket pays 30 cents less tax for every dollar donated. At the same time, the deduction subsidizes the ultimate bene-ficiaries of the charitable activities. The tax system is inconsistent about whether income should be treated as that of transferors or transferees. For instance, child support is treated as income of the transferor; alimony as income of the transferee.

Higher-income individuals generally save more taxes by giving to charity 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-quarters of charitable giving comes directly from individuals, with the balance coming from their foundations, estates, and corporations (figure 1). Total contributions totaled $373.25 billion in 2015.

The deductibility of contributions subsidizes charitable activity but is also sometimes independently justified as an appropriate adjustment to the tax base. Many economists and lawyers argue that a taxpayer's taxable income should be determined by income net of contributions, since a taxpayer with, say, $50,000 of income and $10,000 of con-tributions has no more ability to consume than someone with $40,000 of income and no contributions.

Donors may choose which charitable activities to support. Thus, because part of the cost of their donations is borne by the government through reduced revenue, donors have a say in which activities the government supports.

Some donations fund activities that substitute for those the government might other-wise undertake. Other donations complement government activities, and still others support an adversarial relationship with government. Nonprofits, for instance, may seek further government funding for a given activity, or its members may engage in debates with government officials. Many believe these types of charitable activity make democracies healthier, even when particular chartable efforts have little impact.

Although the tax deduction likely induces additional giving, estimates of the size of this effect vary. Indeed, there is considerable debate over whether the increase in giving exceeds the loss of government revenue.

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Q. How could we improve incentives for charitable giving?

A. Proposals include establishing a floor on deductions in exchange for more effective incentives such as offering a nonitemizer charitable deduction, strengthening the IRA charitable rollover, revising the excise tax on foundations, raising the limit on deductions, and allowing people to claim charitable deductions for the previous year up to the time of filing tax returns, as in the case of deposits to individual retirement accounts.

Under current law, taxpayers who itemize are allowed to deduct most of their charitable contributions, thereby reducing their tax liability. Taxpayers who do not itemize 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. Some of these proposals would replace less effective incentives with more effective ones.

FLOOR ON DEDUCTIONS

One proposal would expand the existing incentive in exchange for a floor on deduc-tions. This makes sense because incentives are more powerful for the incremental dol-lar of giving than for the first dollar.

Consider a person who would give away $1,000 with no tax 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 would have a greater effect than one for the first $100 or even the first $1,000, which would 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 then be used to expand other incentives. For instance, nonitem-izers who give significant amounts to charity might be allowed to deduct some of their charitable contributions.

The revenue gains from a floor could be significant. The Congressional Budget Office estimated that only allowing deductions that exceed 2 percent of adjusted gross in-come (AGI) would increase federal revenue by more than $15 billion a year. A more modest floor would still provide substantial revenues that could be used to increase other, more powerful, incentives to give.

Key Elements of the U.S. Tax System

How could we improve incentives for charitable giving?

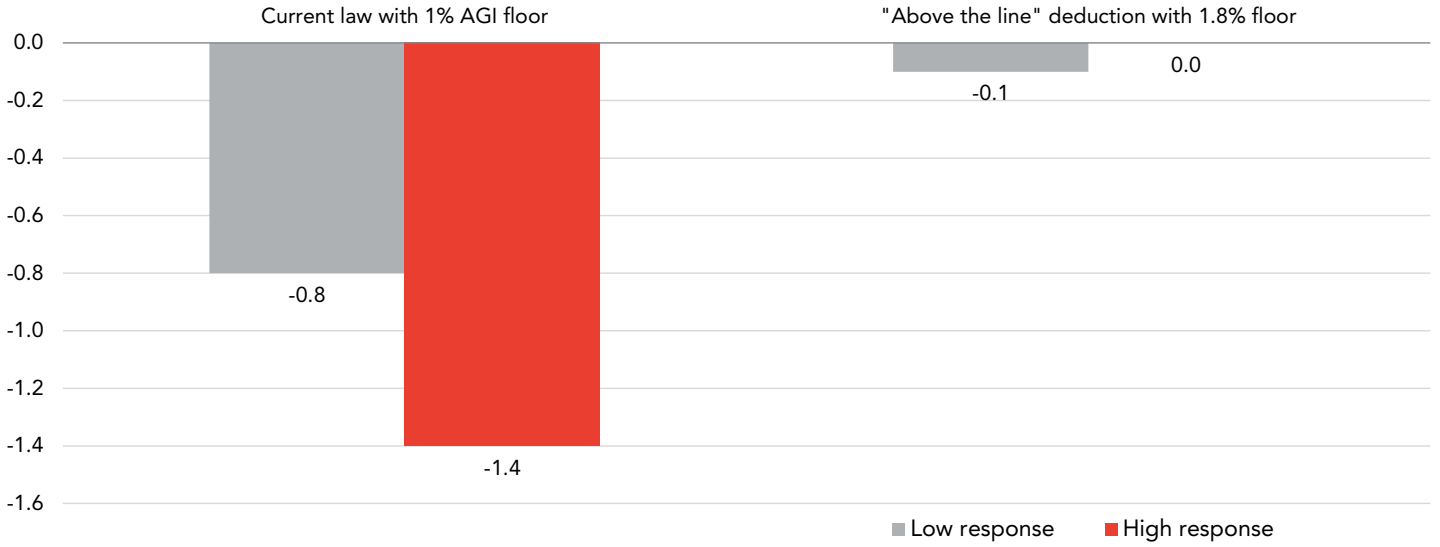
NONITEMIZER DEDUCTION

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 by itself might create compliance problems: the Internal Revenue Service cannot reasonably be expected to audit small donations. Also, offer-ing a deduction to nonitemizers separate from the deduction for itemizers would in-crease the complexity of filing in an already complicated income tax system. Many tax-payers 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 ap-plied 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 1.8 percent of AGI, regardless of whether they itemize. This combination would likely have little impact on charitable giving but would raise as much as $10 billion in tax revenue, and would address concerns about administration and compliance. How much net giving would change depends upon the sensitivity of giving to incentives (figure 1).

FIGURE 1

Impact on Charitable Giving of Options to Change the Charitable Deduction
2011



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

RAISING THE LIMIT ON THE DEDUCTION

Another option would be to raise the limit on deductions above the current 50 percent of AGI. This would significantly increase incentives at the margin for large givers. One could also make the carryover provisions more generous with respect to the 50 percent limit. 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.

Key Elements of the U.S. Tax System

How could we improve incentives for charitable giving?

IRA ROLLOVERS

Yet another proposal would expand the charitable individual retirement account (IRA) rollover provision. This provision allows some taxpayers over age 70 years and 6 months to donate up to $100,000 from traditional IRAs to charity without having to count the distributions as taxable income or separately take an itemizer deduction for already excluded income. Raising or eliminating the $100,000 annual limit on dona-tions, lowering the age limit to 59 years and 6 months (the age at which IRA owners may withdraw funds without penalty), or allowing such giving to be deposited in donor advised funds (currently ineligible for such tax treatment) could increase charitable giving.

FOUNDATION EXCISE TAX

Another option would eliminate or reform the excise tax on foundation income. The current excise tax on income from foundation assets was initially intended to cover the IRS's costs of overseeing the tax compliance of charitable organizations, but the monies were not appropriated. The tax rate is either 1 or 2 percent, depending on whether the year's giving equals or exceeds the average of the last few years. Under these current rules, foundations that give at above-average rates 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 very least, Congress could impose a single tax rate on all such income; this would eliminate the current perverse incentive for foundations to limit current grants today in order to avoid a higher tax in the future.

ALLOWING CHARITABLE DEDUCTIONS UP TO APRIL 15 OR TIME OF FILING TAX RETURNS

Another proposal that passed the House of Representatives, sometimes called the April 15 option, would allow individuals to take charitable deductions up to April 15 or the time of filing tax returns. The proposal costs the government almost nothing if there are no increases in giving because it doesn't really change the subsidy value of gifts already made. In terms of bang per buck, or increased giving per dollar of revenue cost, it ranks very high, since the incentive for the most part only loses revenues when there are additional gifts. Economic and marketing evidence supports the notion that people would give more because they would be more aware of the size of the incentive; meanwhile, tax return preparers and tax software developers would help advertise the opportunity at hand, and people would receive immediate rather than delayed support for their contributions.

How could we improve incentives for charitable giving?

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Q. How large are individual income tax incentives for charitable giving?

A. The individual income tax deduction for charitable giving provides a substantial incentive to give by reducing the economic cost of making a donation. In 2017, charitable giving by individuals is estimated to reach $292 billion at an annual revenue loss of approximately $57 billion.

An income tax deduction for charitable giving is available only to taxpayers who itemize their deductions. Estimates from the Tax Policy Center suggest that for 2017, charitable giving by individuals could reach a total of $292 billion. Itemizers are estimated to provide about 82 percent of total charitable giving; nonitemizers provide about 18 percent of total charitable giving (table 1).

Charitable Giving by Itemizers and Nonitemizers

TABLE 1

Estimated Charitable Giving by Itemizers and Nonitemizers, 2017

Under current law

Current law baseline	Itemizers	Nonitemizers
Number of tax units	45,460	129,220
Percentage of total tax units	26	74
Total giving ($ billions)	239	53
Percentage of total giving	82	18

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Giving by Income Group

Charitable giving patterns differ by income. Some research indicates that the value of the charitable deduction provides greater incentive for higher-income individuals because they face higher marginal rates, are more likely to itemize, and can give more to charity. Tax proposals that reduce incentives for higher-income individuals will have a disproportionate effect on the charities to which these individuals are more likely to give, such as higher education and museums. Table 2 shows the amount of charitable giving by adjusted gross income.

Key Elements of the U.S. Tax System

How large are individual income tax incentives for charitable giving?

TABLE 2

Returns with Itemized Deductions: Estimated Amount of Charitable Contributions by Adjusted Gross Income

Tax year 2014, (Filling year 2015)

AGI category	Total AGI ($ thousands)	Total itemized contributions ($ thousands)
Under $5,000	955,740	134,337
$5,000 to under $10,000	3,359,968	341,169
$10,000 to under $15,000	8,169,789	637,755
$15,000 to under $20,000	15,328,409	1,149,321
$20,000 to under $25,000	21,672,869	1,509,083
$25,000 to under $30,000	32,646,115	2,151,621
$30,000 to under $35,000	41,969,826	2,324,693
$35,000 to under $40,000	52,640,593	2,401,840
$40,000 to under $45,000	66,729,093	2,982,981
$45,000 to under $50,000	74,052,828	3,235,184
$50,000 to under $55,000	82,706,027	3,388,894
$55,000 to under $60,000	93,794,233	3,694,880
$60,000 to under $75,000	302,979,889	10,814,141
$75,000 to under $100,000	634,243,182	19,945,031
$100,000 to under $200,000	1,876,134,643	48,902,399
$200,000 to under $500,000	1,352,486,670	31,660,400
$500,000 to under $1,000,000	529,449,597	13,530,016
$1,000,000 to under $1,500,000	200,173,458	6,016,733
$1,500,000 to under $2,000,000	121,057,243	3,752,949
$2,000,000 to under $5,000,000	301,110,263	10,318,593
$5,000,000 to under $10,000,000	173,629,968	6,974,756
$10,000,000 or more	497,720,321	34,732,005
All returns	**6,483,010,725**	**210,598,779**

Source: Internal Revenue Service, Statistics of Income Division, 2014.

Note: AGI = adjusted gross income. Table only captures charitable donations reported to the Internal Revenue Service.

Average Incentive

The after-tax cost of giving is the value of the gift minus any tax benefits received. If an itemizing taxpayer with a marginal tax rate of 28 percent (that is, the tax rate on the last dollars of income) gives $100 to a local college, for instance, the gift reduces the income tax bill for that person by $28, so the deductible charitable gift has a net cost of only $72. The $28 is the amount of the federal subsidy for giving. If the taxpayer had a 40 percent tax rate, the donation becomes even less costly, at only $60. In other words, as tax rates increase, the after-tax "price" of charitable giving decreases.

Figure 1 shows a summary of the average after-tax price of charitable giving under current law. The average after-tax federal subsidy is 20.8 percent. Note that taxpayers in the top 1 percent have the lowest after-tax price of charitable giving.

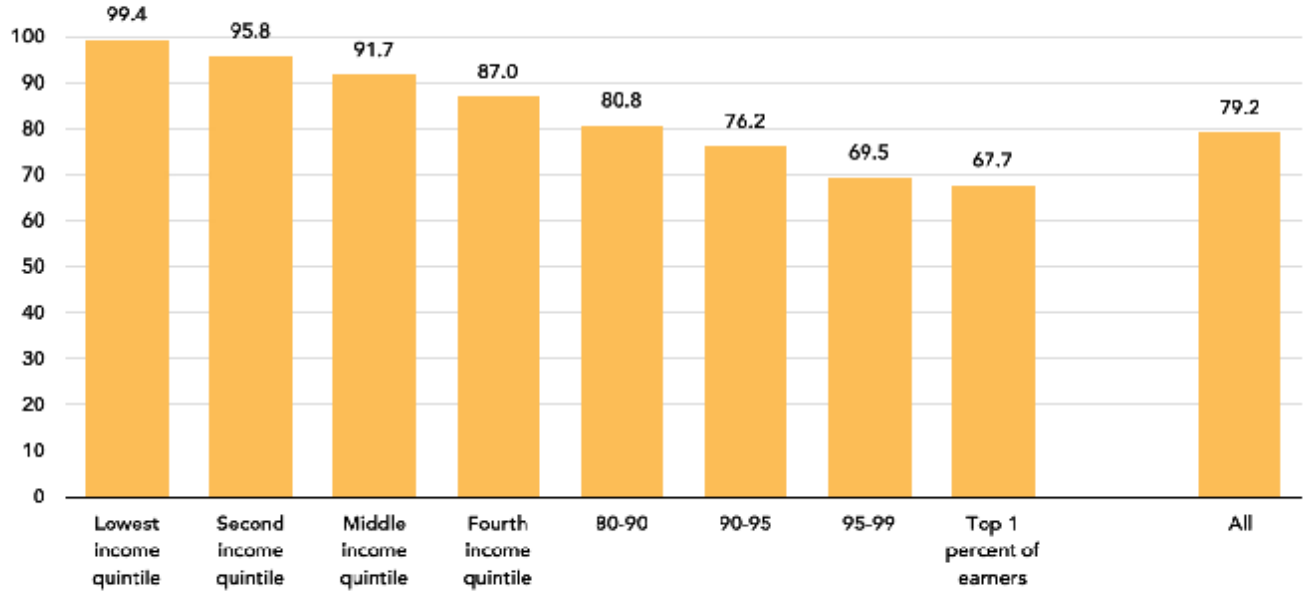
Key Elements of the U.S. Tax System

How large are individual income tax incentives for charitable giving?

FIGURE 1

Estimated Average After-Tax Price of Charitable Giving, 2017

By expanded cash income percentile, under current law



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: Graph depicts the average marginal after-tax price of a $100 donation.

Estimated Revenue Loss from Charitable Gifts, 2016- 20

The size of the after- tax price of charitable giving can have significant policy implications. For example, if losses in federal revenue from allowing the charitable deduction are greater than the increase in charitable giving caused by the deduction, then the entire amount of the federal subsidy for giving does not flow through to the charitable organizations receiving the gifts. The charitable deduction is estimated to cost approximately $57 billion in 2017 and $293 billion over five years (2016–20).

TABLE 3

Estimated Tax Expenditures by Charitable Deductions

Fiscal years 2016–20 ($ billions)

Charitable deductions	2016	2017	2018	2019	2020
Educational institutions	$9.3	$9.6	$9.9	$10.2	$10.5
Health organizations	$4.4	$4.5	$4.6	$4.7	$4.9
Other	$41.5	$42.8	$44.1	$45.2	$46.6
Total	$55.2	$56.9	$58.5	$60.1	$62.0

Source: Joint Committee on Taxation (2017, 37–39).

Key Elements of the U.S. Tax System

How large are individual income tax incentives for charitable giving?

Limits on the Charitable Deduction

The charitable deduction has many limits. Among them are the following:

- The charitable deduction is only available for a subset of qualifying, tax-exempt organizations that are charitable in nature, as defined in section 501(c)(3) of the tax code.
- Contributions for individuals are generally allowed up to 50 percent of adjusted gross income, but there is a 30 percent limit for contributions to a foundation and certain other organizations and a 30 percent limit for contributions of capital gain property. Deductible contributions for corporations are limited to 10 percent of corporate income.
- Contributions to many tax-exempt organizations, such as unions and chambers of commerce, are not deductible, though income earned on assets within those organizations generally are excluded from taxation.

Data Sources

Internal Revenue Service, "Statistics of Income Tax Stats: Individual Income Tax Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items," classified by size of adjusted gross income, tax year 2014.

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Philip Stallworth, Chenxi Lu, and C. Eugene Steuerle, "Both Clinton and Trump would reduce tax incentives for charitable giving," TaxVox (blog), November 4, 2016.

Q. How might tax reforms reduce incentives for charitable giving?

A. Tax reforms can reduce charitable giving through direct and indirect changes to the tax code. The indirect effects are often greater than the direct effects from changes in rules related to charitable giving.

Several recently proposed tax reforms would, indirectly, reduce incentives for charitable giving. These reforms include reductions in marginal tax rates, caps on total itemized deductions, caps on the maximum tax rate at which all itemized deductions can be allowed, increases to the standard deduction or reductions in other itemized deductions, and elimination or reduction of the estate tax.

Reductions in marginal tax rates increase after-tax costs for charitable donations, thereby reducing the incentive to give. If an itemizing taxpayer with a tax rate of 39.6 percent gives $100 to a local college, for example, that charitable deductible gift has an after-tax cost to the taxpayer of $60.40 because of the $39.60 reduction in his or her income tax bill. If that tax rate is reduced to 33 percent, the after-tax of the donation would increase to $67 because the federal subsidy for giving falls from $39.60 to $33.

Caps on total itemized deductions could also reduce charitable giving because the caps reduce, and in many cases remove, incentives for high-income taxpayers to give. During the 2016 presidential campaign, for instance, President Trump proposed an overall cap on itemized deductions of $100,000 per single return and $200,000 per joint return. Higher-income taxpayers with mortgage interest, property tax, and other deductions in excess of such amounts would have no tax incentives to give to charity because charitable gifts would not add to their deductions. Though only a small percentage of taxpayers have such high incomes, research suggests that high-income tax payers are more responsive to tax reforms that affect charitable giving because they have more income, more tax advisers, and more incentive to devote time to figuring out the after-tax price of giving.

A maximum cap on the subsidy rate for itemized deductions also reduces the incentive to give because it increases the after-tax cost of giving. For instance, if the top statutory tax rate is 39.6 percent, but the maximum subsidy rate is set at 28 percent, then the subsidy for those in that 39.6 percent bracket would be reduced by more than one-quarter. President Obama proposed this type of cap.

Key Elements of the U.S. Tax System

How might tax reforms reduce incentives for charitable giving?

Increases to the standard deduction or reductions in other itemized deductions also reduce incentives to give by reducing the number of taxpayers who itemize their deductions. These types of changes have been common to many tax reforms. Currently, itemizers are estimated to provide about 82 percent of total giving, about $239 billion; nonitemizers, who on average have lower incomes, provide about 18 percent of total charitable giving, about $53 billion. If fewer people itemize, fewer people have a tax incentive to give.

Eliminating or reducing the estate tax could also negatively affect charitable giving because such tax reform reduces higher-income individuals' incentive to give. The estate tax encourages charitable giving by allowing a deduction for charitable bequests. One study published in 2003, when the top estate tax rates were higher than today, estimated that estate tax repeal could reduce charitable bequests between 22 and 37 percent.

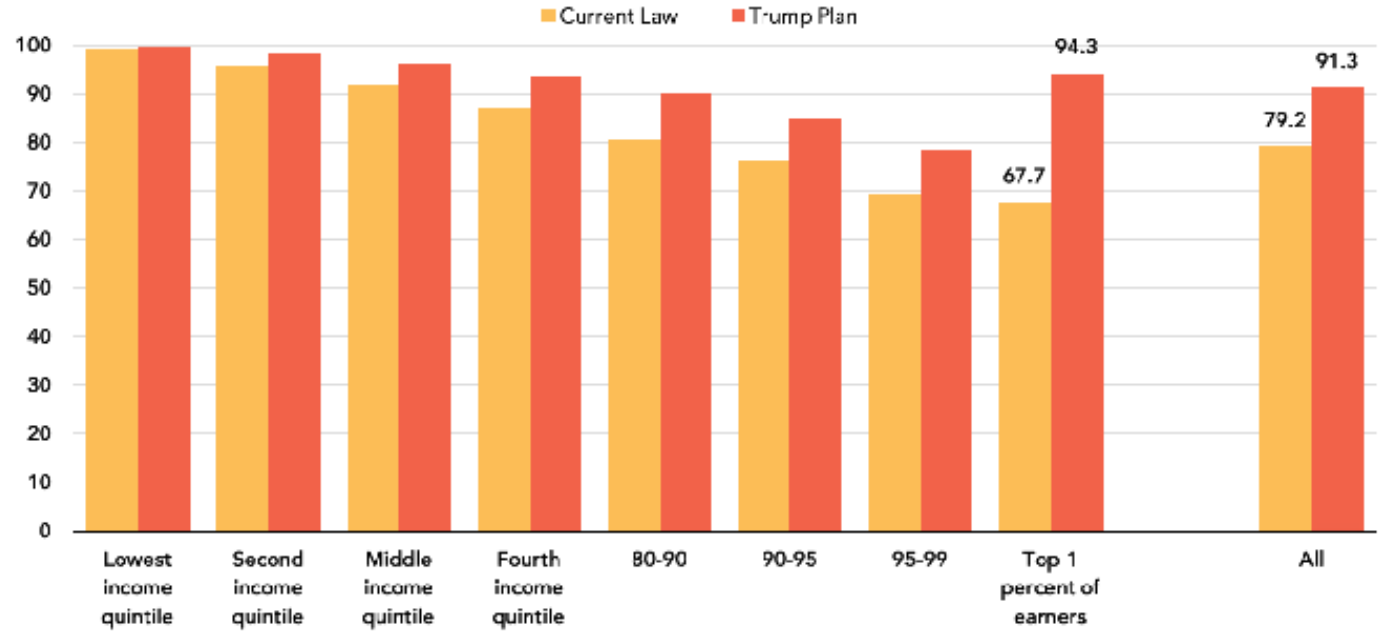
Examples from Some Recent Tax Reform Proposals

Donald Trump's campaign tax plan proposed reductions in marginal tax rates and overall caps on itemized deductions. Figure 1 shows how these tax reform proposals would indirectly affect charitable giving by increasing the average after-tax price of giving from $79.20 to $91.30, thereby reducing the incentive to give. Households in the top 1 percent are the most affected by Trump's proposed rate cuts and overall caps on itemized deductions; their average after tax-price of giving would rise from $67.70 to $94.30.

FIGURE 1

Estimated Average After-Tax Price of Charitable Giving, 2017

By expanded cash income percentile, under current law



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: Graph depicts the average marginal after-tax price of a $100 donation.

Key Elements of the U.S. Tax System

How might tax reforms reduce incentives for charitable giving?

House Committee on Ways and Means Chairman Dave Camp's tax plan proposed different tax reforms that could have affected charitable giving in different ways. For example, the plan proposed lowering tax rates, increasing the standard deduction, limiting itemized deductions other than charity, limiting maximum charitable deductions annually to 40 percent of adjusted gross income, and allowing charitable deductions only above a floor of 2 percent of adjusted gross income. Overall, estimates from the Tax Policy Center show that Chairman Camp's tax plan would have reduced individual giving in the range of 7 to 14 percent, which corresponds to a reduction of between 17 and 34 billion dollars based on 2013 giving levels (table 1). Note that multiple interactions in this case make the combined effect of many provisions greater than the sum of their parts.

TABLE 1

Effect of Chairman Dave Camp's Proposals on Charitable Giving

Estimated percentage-point reductions in charitable giving

Camp tax reform tax plan (total)	Rate structure	Standard deduction and other nonitemized deduction provisions	Itemized deductions other than charity	Charitable deduction	Residual because of interactions
7.0–14.0	0.9–1.9	0.9–1.8	1.2–2.6	2.2–4.4	1.6–3.1

Source: Rosenberg et al. (2014).

Note: Numbers do not total 7.0–14.0 because of rounding.

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Rosenberg, Joseph, C. Eugene Steurele, Ellen Steele, and Amanda Eng. 2014. "Preliminary Estimates of the Impact of the Camp Tax Reform Plan on Charitable Giving." Washington, DC: Urban-Brookings Tax Policy Center.

Q. How much does the federal government spend on health care?

The federal government will spend more than $1,124 billion in fiscal year 2017. In addition, tax expenditures for health care will total nearly $260 billion.

FEDERAL SPENDING ON HEALTH CARE IN 2017

The Congressional Budget Office and the Office of Management and Budget estimate that the federal government will spend more than $1,124 billion on health care in fiscal year 2017 (see table 1). Of that, Medicare will claim roughly $593 billion, Medicaid and the State Children's Health Insurance Program (SCHIP) about $407 billion, veterans' medical care about $71 billion, and subsidies for the Affordable Care Act's health insurance exchanges about $54 billion. In addition to these direct outlays, various tax provisions for health care create tax expenditures that total nearly $260 billion. About 60 percent of that figure comes from the exclusion from taxable income of employers' contributions for medical insurance premiums and medical care.

Key Elements of the U.S. Tax System

How much does the federal government spend on health care?

TABLE 1

Estimated Federal Spending and Tax Expenditures for Health Care

FY 2017

Program	Millions of dollars
Spending	
Spending for Medicare net of offsetting receipts	593,041
Medicaid and SCHIP	407,019
Veterans' medical care	70,600
Exchange subsidies and related spending	54,181
Tax expenditures[c]	
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	151,400
Subsidies for insurance purchased through health benefit exchanges[b]	72,500
Deduction for medical expenses and long-term care expenses	11,400
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	5,400
Exclusion of workers' compensation benefits (medical benefits)	5,100
Deduction for charitable contributions to health organizations	3,400
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	2,800
Health savings accounts	2,400
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit hospital facilities	2,000
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare	1,000
Tax credit for small businesses purchasing employer insurance	600
Credit for orphan drug research	<50

Sources: Congressional Budget Office, Updated Budget Projections: 2016 to 2026; Office of Management and Budget, Budget of the United States Government FY2017, Historical Tables; Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2014-18.

(a) Figure only includes lost income tax revenues. Including income and payroll taxes the exclusion reduces federal revenue by $260 billion.

(b) JCT estimates thatexchange subsidies will reduce tax revenues by $72.5 billion and result in outlays of $177.1 billion in 2017.

(c) JCT no longer classifies the exlusion of Medicare benefits as a tax expenditure.

Data Sources

Congressional Budget Office. 2017. "Updated Budget Projections: 2016 to 2026." Report 51908. Washington, DC: Congressional Budget Office.

Joint Committee on Taxation. 2015. "Estimates of Federal Tax Expenditures for Fiscal Years 2015–2019." JCX-97-14. Washington, DC: Joint Committee on Taxation.

Office of Management and Budget. Budget of the United States Government FY2017. "Historical Tables." February 2016.

Q. Who has health insurance coverage?

A: Eighty-three percent of nonelderly individuals were covered in 2013, with rates rising sharply with income. Since then, the ACA has increased total coverage among non-elderly adults by more than 7 percentage points.

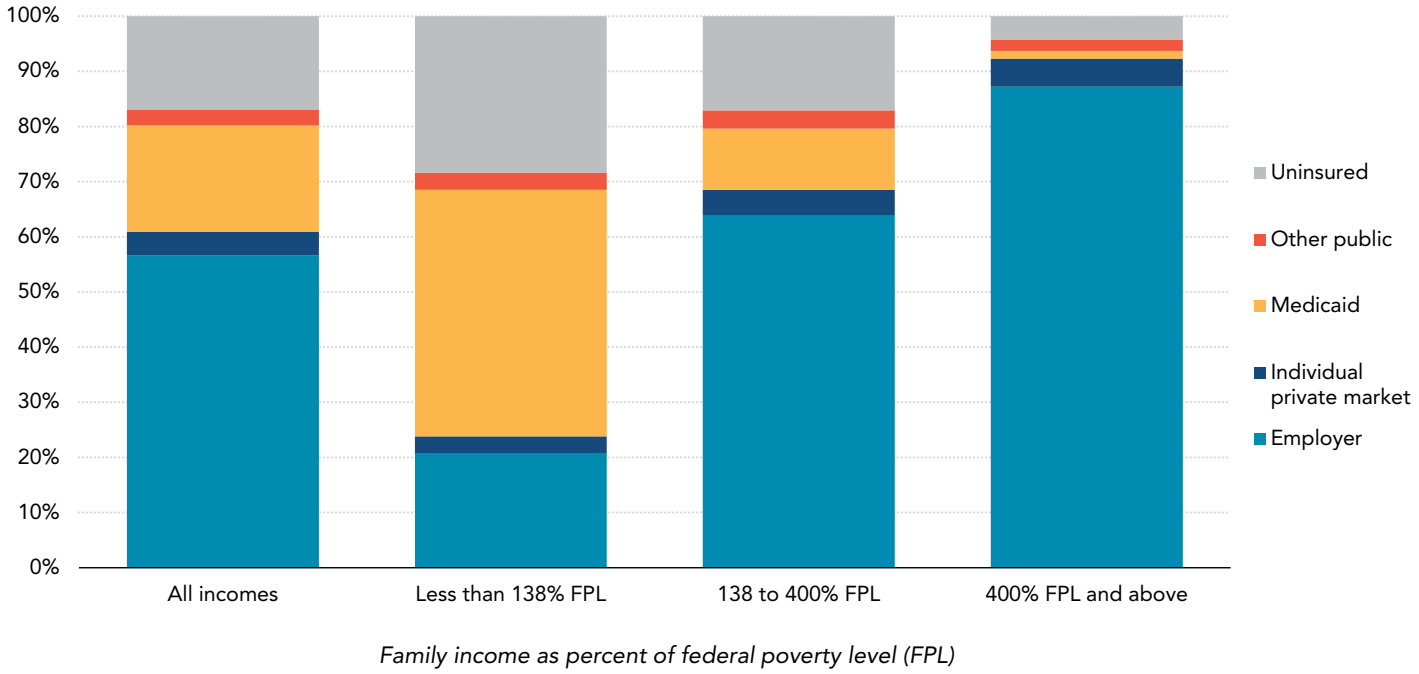
In 2013, before the major coverage expansions under the Affordable Care Act (ACA), nearly 57 percent of the nonelderly population obtained health insurance coverage through employment (see figure 1). Another 4 percent purchased coverage on their own in the private market, while about 19 percent were covered by Medicaid and 3 percent had coverage from other public sources. That left nearly 17 percent unin-sured. Virtually all elderly individuals participate in Medicare, and those with low in-comes also receive assistance through Medicaid.

Key Elements of the U.S. Tax System

Who has health insurance coverage?

FIGURE 1

Health Insurance Coverage of the Nonelderly by Income
2013



Source: Kaiser Commission on Medicaid and the Uninsured, "Health Insurance Coverage in 2013: Gains in Public Coverage Continue to Offeset Loss of Private Insurace," Table 1, Appendix A.
Notes: Other public insurance includes Medicare and military-related coverage. State Children's Health Insurance Programs (SCHIP) is included in Medicaid.

Health insurance coverage rises sharply with income. Less than one-quarter of the nonelderly with family incomes below 138 percent of the federal poverty level (FPL) had private coverage in 2013; 28 percent reported having no health insurance, public or private. In contrast, more than two-thirds of those with incomes between 138 and 400 percent of FPL had private coverage, while 17 percent had no insurance. Over 90 percent of the nonelderly with incomes above 400 percent of FPL had private cover-age, and just 4 percent lacked any health insurance.

Who has health insurance coverage?

GAINS IN HEALTH INSURANCE COVERAGE SINCE 2013

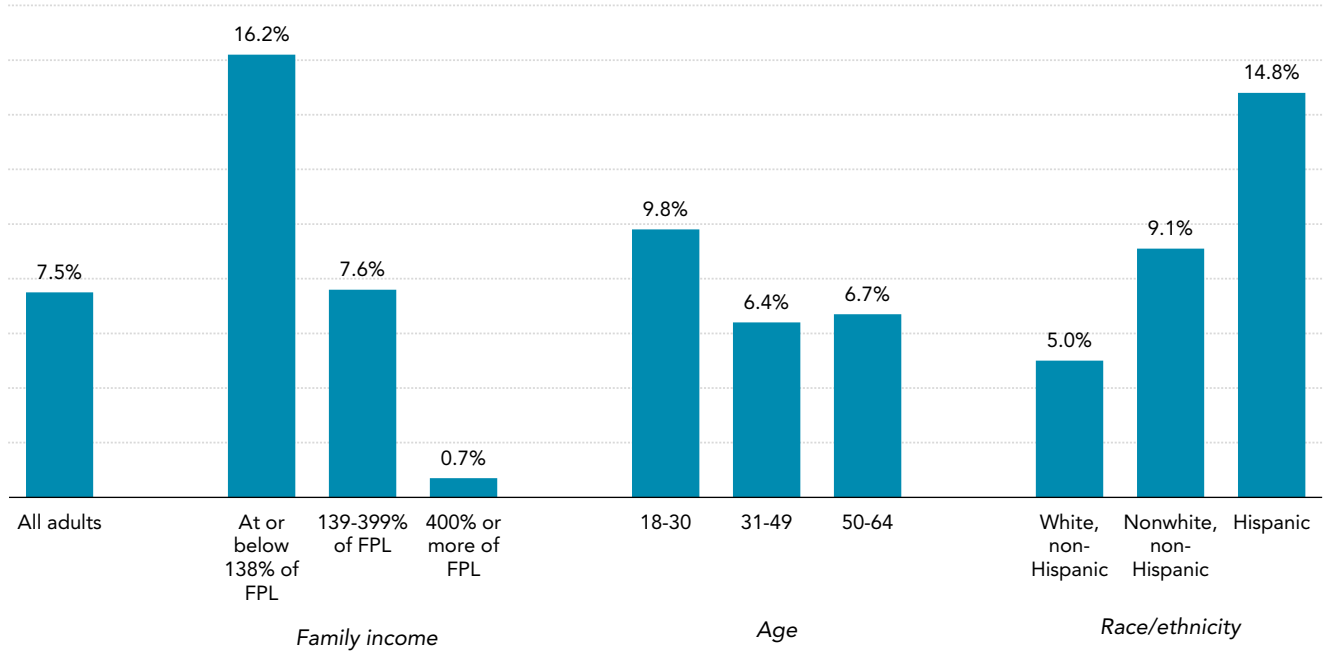
Coverage has increased markedly since implementation of the Affordable Care Act in 2014. Under the ACA, families with incomes between 100 and 400 percent of FPL, lacking other affordable health insurance options, can use tax credits to purchase in-surance on national or state exchanges. Additionally, states may expand Medicaid eli-gibility to all nonelderly with incomes below 138 percent of FPL, with the federal gov-ernment initially paying the entire cost.

Estimates from the Urban Institute's Health Reform Monitoring Survey (2015) show that between fall 2013 and spring 2015 the percentage of adults under age 65 with health insurance increased by 7.5 percentage points (see figure 2). Gains have been largest among low- and moderate-income families, the young, and racial and ethnic minorities.

FIGURE 2

Percentage-Point Increase in Insurance Coverage for Adults Ages 18–64

Between quarter 3, 2013 and quarter 1, 2015



Source: Urban Institute, 2015.
Note: FPL = federal poverty level.

Data Sources

Kaiser Commission on Medicaid and the Uninsured. 2015. "Health Insurance Cover-age in 2013: Gains in Public Coverage Continue to Offset Loss of Private Insurance." Menlo Park, CA: Henry J. Kaiser Family Foundation.

Urban Institute. 2015. "Taking Stock: Gains in Health Insurance Coverage under the ACA as of March 2015." Washington, DC: Urban Institute.

Q. What tax provisions subsidize the cost of health care?

A. A host of tax preferences for health care will cost the federal government roughly $250 billion in revenue in 2015. The largest is the exclusion from taxable income of employer contributions for health insurance premiums.

EXCLUSION FOR EMPLOYER CONTRIBUTIONS TO HEALTH INSURANCE

In 2015, the federal government will lose roughly $250 billion in income tax revenue from at least 10 tax preferences for health care. By far the most costly is the exclusion of employer contributions for health insurance premiums from taxable income. In most cases, employee contributions to health insurance premiums are excluded from income taxes. The Joint Committee on Taxation estimates tax expenditures on the exclusion for employer-sponsored health insurance will be $150.6 billion in fiscal year 2015.

TABLE 1

Tax Expenditures for Health Care

Millions of dollars, 2017

Tax expenditures[c]	Millions of dollars
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	151,400
Subsidies for insurance purchased through health benefit exchanges[a]	72,500
Deduction for medical expenses and long-term care expenses	11,400
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	5,400
Exclusion of workers' compensation benefits (medical benefits)	5,100
Deduction for charitable contributions to health organizations	3,400
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	2,800
Health savings accounts	2,400
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit hospital facilities	2,000
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare	1,000
Tax credit for small businesses purchasing employer insurance	600
Credit for orphan drug research	<50

Sources: Joint Committee on Taxation.

(a) JCT estimates that exchange subsidies will reduce tax revenues by $72.5 billion and result in outlays of $177.1 billion in 2017.

(b) Figure only includes lost income tax revenues. Including income and payroll taxes the exclusion reduces federal revenue by $260 billion.

(c) JCT no longer classifies the exlusion of Medicare benefits as a tax expenditure.

OTHER MAJOR TAX EXPENDITURES FOR HEALTH CARE

Table 1 outlines the major federal tax expenditures for health care:

- Medicare benefits are excluded from taxable income ($64.3 billion).
- Individuals may claim as an itemized deduction out-of-pocket medical expenses and health insurance premiums paid with after-tax dollars and exceeding 10 percent of their adjusted gross income ($11.0 billion).
- By the same token, self-employed individuals may deduct health insurance premiums from their income ($5.6 billion).
- Individuals ineligible for employer-sponsored or public health insurance may use tax credits to purchase insurance on ACA exchanges ($5.4 billion).
- Corporations and individuals may claim contributions to qualified health organizations as itemized deductions if the contributions are less than half of their adjusted gross income ($5.1 billion).
- Medical benefits provided by workers' compensation insurance are excluded from taxable income ($4.9 billion).
- Coverage for military retirees and dependents is excluded from taxable income ($3.2 billion).
- Interest on certain bonds issued for hospital construction is excluded from taxable income ($2.5 billion).
- Individuals under 65 covered by high-deductible health insurance plans may take an income tax deduction for contributions to health savings accounts (HSAs). Employers may make HSA contributions that are excluded from income taxes. Additionally, HSA balances grow tax free, and withdrawals for medical expenses are not subject to income tax ($1.9 billion).
- Small employers who pay low average wages may take a credit when providing employees with health insurance. The credit phases out as firm size and average wages increase; it can only be taken for two years ($1.5 billion).
- Pharmaceutical companies testing drugs for rare diseases may claim the orphan drug credit ($0.8 billion).

Data Sources

Joint Committee on Taxation. *Estimates of Federal Tax Expenditures for Fiscal Years 2014–*

Further Reading

Gruber, Jonathan. 2011. "The Tax Exclusion for Employer-Sponsored Health Insurance." *National Tax Journal* 64(2, part 2): 511–30.

Joint Committee on Taxation, Tax Expenditures for Health Care (JCX-66-08), July 30, 2008.

Q. How does the tax exclusion for employer-sponsored health insurance work?

A. The exclusion lowers the after-tax cost of health insurance for most Americans.

Employer-paid premiums for health insurance are exempt from federal income and payroll taxes. Additionally, the portion of premiums paid by employees is typically ex-cluded from taxable income as well. The exclusion of premiums lowers most workers' tax bills and thus reduces their after-tax cost of coverage. This tax subsidy partly ex-plains why most American families have health insurance coverage through employers. Other factors play a role though, notably the economies of group coverage.

ESI EXCLUSION IS WORTH MORE TO TAXPAYERS IN HIGHER TAX BRACKETS

Because the exclusion of premiums for employer-sponsored insurance (ESI) reduces taxable income, it is worth more to taxpayers in higher tax brackets than to those in lower brackets. Consider a worker in the 15 percent income-tax bracket who also faces a payroll tax of 15.3 percent (7.65 percent paid by the employer and 7.65 percent paid by the employee). If his employer-paid insurance premium is $1,000, his taxes are $281 less than they would be if the $1,000 was paid as taxable compensation. His after-tax cost of health insurance is thus $1,000 minus $281, or $719. In contrast, the after-tax cost of a $1,000 premium for a worker in the 25 percent income tax bracket is just $626 ($1,000 minus $374). Savings on state and local taxes typically lower the after-tax cost of health insurance even more.

ESI EXCLUSION IS COSTLY

The ESI exclusion cost the federal government an estimated $260 billion in income and payroll taxes in 17 making it the single largest tax expenditure. Note, too, that the open-ended nature of the tax subsidy has likely increased health care costs by encouraging the purchase of more comprehensive health insurance policies with lower cost sharing or with less tightly managed care.

Replacing the ESI exclusion with a tax credit would equalize tax benefits across tax-payers in different tax brackets, as well as between those who get their 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. And designing the credit so that it does not subsidize insurance on the margin (i.e., to be a fixed dollar amount as opposed to a percentage of the premium) could lower health care costs.

[1] These examples assume that workers bear the full burden of employer payroll taxes. Note that the effective mar-ginal tax rates (28.1 percent for the worker in the 15 percent income-tax bracket and 37.4 percent for the worker in 25 percent income-tax bracket) are less than the sum of the income tax and payroll tax rates (30.3 percent and 40.3 percent, respectively) because those rates are applied to compensation after the employer's share of payroll taxes has been deducted. Thus, for example, if the employer increases compensation by $1,000, cash wages only increase by $929 [calculated as $1,000 / (1+employer payroll tax rate)], because the employer would have to pay additional employer payroll taxes of $71. The lower-wage worker's resulting combined income and payroll tax would be 30.3 percent of $929 or $281. The higher-wage worker's resulting combined income and payroll tax would be 40.3 percent of $929 or $374.

Data Sources

Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2014–18.

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0516-1."

Further Reading

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Burman, Leonard E., Jason Furman, Greg Leiserson, and Roberton Williams. 2007. "The President's Proposed Standard Deduction for Health Insurance: An Evaluation." Washington, DC: Urban-Brookings Tax Policy Center.

Gruber, Jonathan. 2011. "The Tax Exclusion for Employer-Sponsored Health Insurance." National Tax Journal 64(2, part 2): 511–30.

Q. How does the employer-sponsored insurance exclusion affect health insurance coverage?

A. It modestly increases health insurance coverage, but the benefit is poorly targeted.

HEALTH INSURANCE EXCLUSION MODESTLY INCREASES HEALTH INSURANCE COVERAGE

In 2015, 84 percent of private-sector employees worked for companies offering em-ployer-sponsored health insurance (ESI), and 57 percent of the nonelderly population were covered by ESI as policyholders or dependents.

One reason so many people are covered through their employers is that ESI benefits are excluded from taxable income. The exclusion reduces workers' tax bills, which lowers their after-tax cost of insurance. However, there are other important reasons for the prevalence of ESI, including low administrative costs and the benefits of risk pooling across groups of workers.

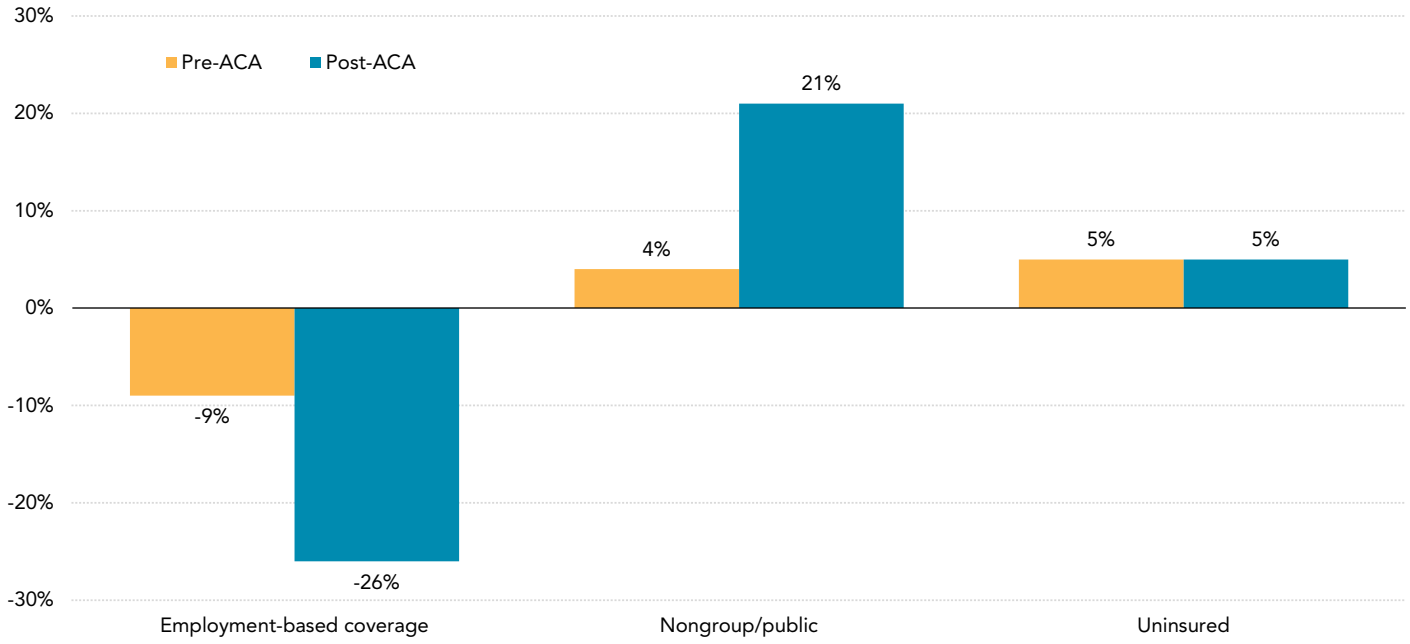
Research examining how marginal tax rates correlate with the portion of employers offering ESI suggests that large and medium-size employers are not very sensitive to changes in after-tax insurance costs. That's why simulation models find that eliminating the ESI exclusion would only modestly affect coverage. According to the Congressional Budget Office (CBO), estimates that do not include the effects of the Affordable Care Act (ACA) show that eliminating the ESI exclusion would reduce the number of insured by 6 percent. CBO estimates that though ESI coverage would decline by 15 percent, the number of people covered by private nongroup or public coverage would increase by 16 percent, offsetting a portion of that decline (figure 1).

The ACA's health insurance exchanges, related subsidies, and Medicaid expansion have increased the attractiveness of private nongroup and public coverage. Low- and moderate-income families may qualify for premium credits or expanded Medicaid, and the exchanges give families access to savings associated with stable risk pools and lower administrative costs. When taking into account the new exchanges, subsidies, and expanded Medicaid under the ACA, the CBO finds that eliminating the ESI exclusion would result in significantly more shifting from ESI to non-group/public coverage. However, the number of insured would still decrease by only 6 percent.

How does the employer-sponsored insurance exclusion affect health insurance coverage?

FIGURE 1

Impact on Coverage of Repealing Health Insurance Exclusion



Source: Congressional Budget Office, "Coverage Effects of Limiting the Tax Exclusion for Employment-Based Health Insurance." Presentation at the Fifth Biennial Conference of the American Society of Health Economists, 2014. https://www.cbo.gov/publication/45456.

HEALTH INSURANCE EXCLUSION IS POORLY TARGETED

Because low-wage workers are less likely to have the option of ESI, and because the benefit of the exclusion increases with workers' marginal tax rates, ESI is worth more to the higher-income families who would be more likely to purchase insurance in the first place. In 2015, less than 30 percent of families in the bottom income quintile were offered ESI; for them, the average benefit of the ESI exclusion was less than $10 (figures 2 and 3). In contrast, nearly 90 percent of families in the top quintile have ESI offers and the average benefit is almost $3,200.

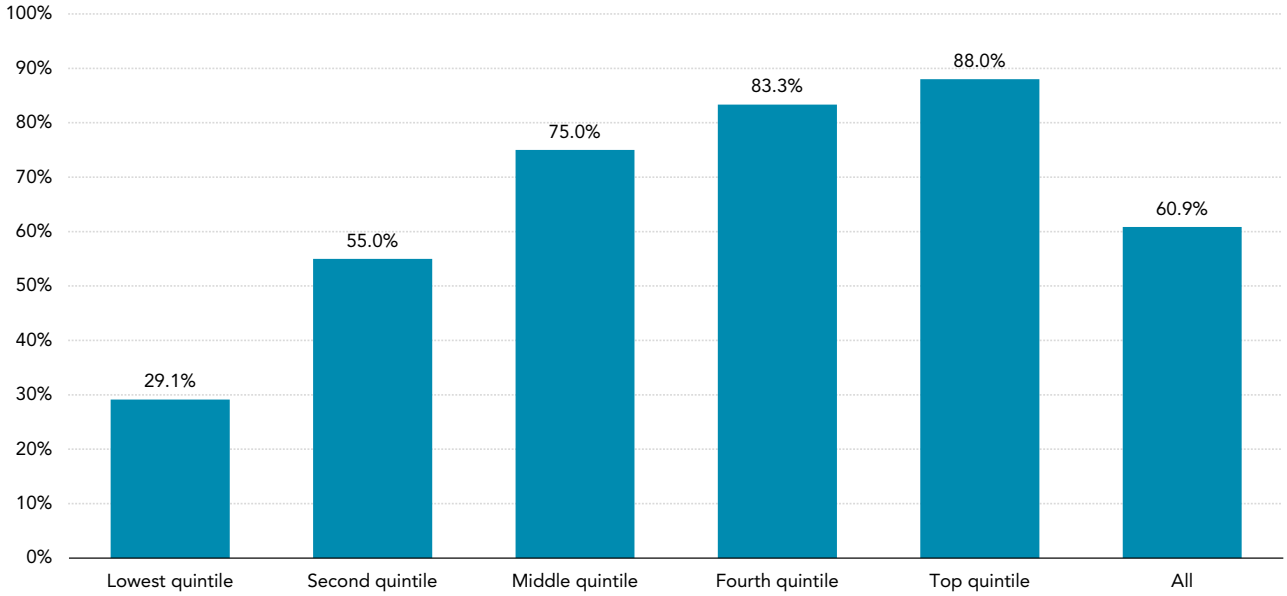
Replacing the exclusion with a refundable tax credit that could be used for either ESI or nongroup insurance would provide low- and moderate-income families with more benefits. Families without ESI would benefit, and converting the tax deduction to a tax credit would mean that everyone with a given level of insurance could claim the same subsidy. Simulations show that better targeted health insurance subsidies could increase coverage for the same total cost.

Key Elements of the U.S. Tax System

How does the employer-sponsored insurance exclusion affect health insurance coverage?

FIGURE 2

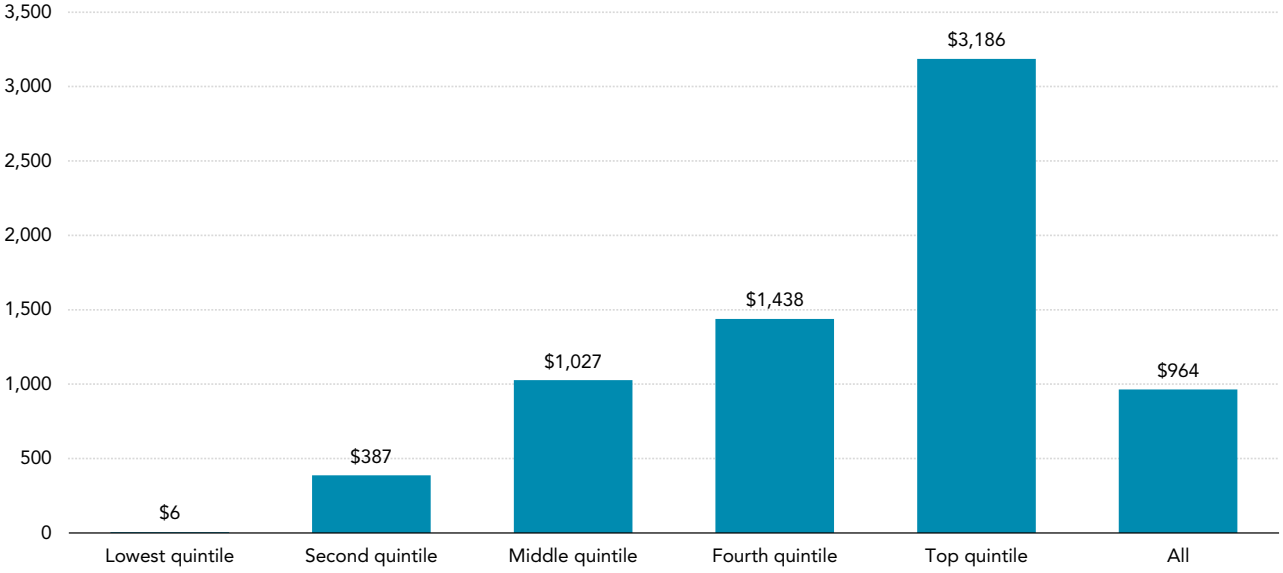
Percentage of Tax Units with ESI Offers by Income Quintile
2015



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

FIGURE 3

Average Tax Benefit of the Exclusion of Employer-Sponsored Health Benefits
$2015



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).
Notes: Tax benefits include exclusion from income of employer-sponsored health, dental, and vision insurance premiums; and contributions to Health Savings Accounts, Health Reimbursement Arrangements, and Medical Flexible Spending Accounts. Tax benefits also include the deduction for self-employed health

Key Elements of the U.S. Tax System

How does the employer-sponsored insurance exclusion affect health insurance coverage?

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Q. What are premium tax credits?

A. The Affordable Care Act provides families with refundable, advanceable tax credits to purchase health insurance through exchanges. Premium credits cap contributions as a share of income for families with incomes between 100 and 400 percent of the federal poverty level.

ACA TAX CREDITS FOR HEALTH INSURANCE

The Affordable Care Act (ACA) provides families with refundable tax credits to pur-chase health insurance through both state and federal exchanges—an arrangement confirmed by the Supreme Court. Tax filers can claim premium credits if they (1) have incomes between 100 and 400 percent of the federal poverty level (FPL), (2) are ineli-gible for adequate and affordable health insurance from other sources, and (3) are le-gal residents of the United States. Tax filers with incomes between 100 and 138 per-cent of the FPL are generally ineligible for premium credits if they reside in states that take advantage of the ACA's expansion of Medicaid eligibility.

CALCULATION OF PREMIUM CREDITS

Premium credits effectively cap family contributions as a share of income for those purchasing mid-range "benchmark" plans. In 2017, maximum family contributions ranged from a low of 2.04 percent of income for families at the poverty threshold to 9.69 percent for families between 300 and 400 percent of FPL (table 1). Premium cred-its equal the difference between gross premiums and maximum family contributions.

For example, consider a family of four with income equal to 200 percent of FPL in 2017 that is purchasing an insurance plan costing $15,000. Multiplying family income (here, $48,600) by the applicable 6.43 percent maximum premium results in a family contribution of $3,125 and thus a premium credit of $11,875 ($15,000–$3,125).

The example above assumes the family purchases the second least expensive (Silver) plan from the menu of Bronze, Silver, Gold, and Platinum health insurance plans of-fered through exchanges. If the family purchased a more expensive plan, the credit would remain unchanged and the family would pay the full difference in premiums.

TABLE 1

Tax Expenditures for Health Care

Millions of dollars, 2017

Tax expenditures[c]	Millions of dollars
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	151,400
Subsidies for insurance purchased through health benefit exchanges[a]	72,500
Deduction for medical expenses and long-term care expenses	11,400
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	5,400
Exclusion of workers' compensation benefits (medical benefits)	5,100
Deduction for charitable contributions to health organizations	3,400
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	2,800
Health savings accounts	2,400
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit hospital facilities	2,000
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare	1,000
Tax credit for small businesses purchasing employer insurance	600
Credit for orphan drug research	<50

Sources: Joint Committee on Taxation.

(a) JCT estimates that exchange subsidies will reduce tax revenues by $72.5 billion and result in outlays of $177.1 billion in 2017.

(b) Figure only includes lost income tax revenues. Including income and payroll taxes the exclusion reduces federal revenue by $260 billion.

(c) JCT no longer classifies the exlusion of Medicare benefits as a tax expenditure.

ADVANCE PREMIUM CREDITS AND RECONCILIATION

Premium credits are based on a household's income in the tax year premiums are paid. Yet the credits are calculated the following year, when households file their in-come tax returns. However, most participating households receive their tax credits in advance as a reduction in the insurance premium they would otherwise pay. This re-duced premium is based on estimated income, generally from the last tax return filed before en-rollment in health insurance. If actual income in the year of enrollment is less than estimated income, families will qualify for larger credits. If actual income is great-er than estimated income, families will be required to repay part or all of the advance credit.

Fortunately for most households with large income increases, the maximum reconciliation payment is limit-ed. In tax year 2016, the maximum payment ranged from $600 for married couples with incomes below 200 percent of FPL to $2,550 for couples with incomes of at least 300 but less than 400 percent of FPL (see table 2). Families whose income equals 400 percent or more of FPL have no limit on reconciliation payments.

For tax year 2014, 54 percent of families receiving advanced credits had to make rec-onciliation payments. However, analysis of tax refund data suggests that for most low-er-income filers, reconciliation payments will reduce tax refunds rather than require additional payments. Still, reconciliation will likely present hardships for some families receiving advanced premium credits, even if they do not have tax payments due, be-cause many low-income households have grown to rely on tax refunds for pressing needs.

FIGURE 1

Maximum Reconciliation Payment by Income

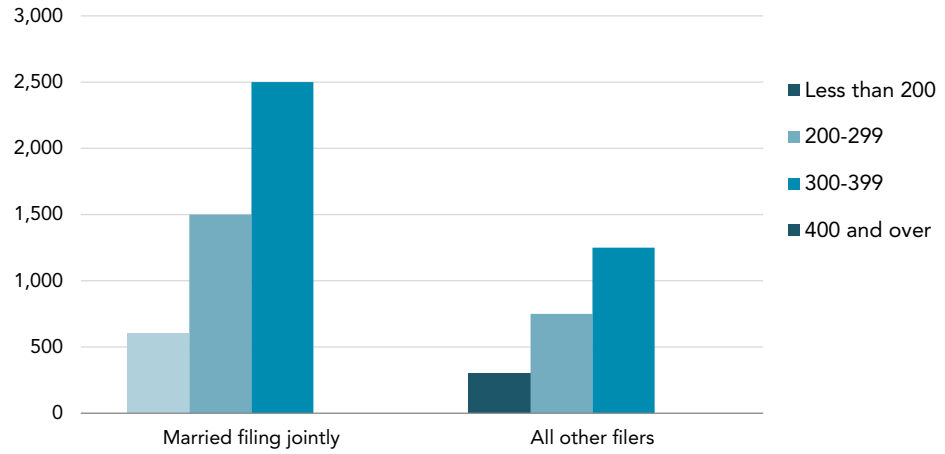

TABLE 2

Maximum Reconciliation Payment

By income level, 2016

Household income as a share of federal poverty level (FPL)	Married filing jointly	All other filers
Less than 200%	$600	$300
200–299%	$1,500	$750
300–399%	$2,550	$1,275
400% and over	unlimited	unlimited

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Q. What is the Cadillac tax?

A. Employer-sponsored health benefits whose value exceeds legally specified thresholds will be subject to a 40 percent excise tax, starting in 2020. The so-called "Cadillac tax" will be levied on insurance companies, but the burden will likely fall on workers. The tax will effectively limit the tax preference for employer-sponsored health insurance.

TAX ON HIGH-COST HEALTH PLANS STARTING IN 2020

Under the Affordable Care Act, employer-sponsored health benefits whose value ex-ceeds specified thresholds will be subject to an excise tax starting in 2020. This "Cadillac tax" will equal 40 percent of the value of health benefits exceeding thresholds projected to be $10,800 for single coverage and $29,050 for family coverage in 2020. The thresholds will be indexed to growth in the consumer price index in subsequent years. Thresholds will be higher for plans with more-expensive than-average demographics, retirees ages 55 to 64, and workers in high-risk professions. The Cadillac tax will apply not only to employers' and employees' contributions to health insurance premiums, but also to health saving account, health reimbursement arrangement, and medical flexible spending account contributions.

WORKERS BEAR THE BURDEN

The tax will be levied on insurance companies, but the burden will likely be passed on to workers in the form of lower wages. Some employers will avoid the tax by switching to less expensive health plans; this will translate into higher wages but also higher income and payroll taxes. In fact, the Joint Committee on Taxation and the Congressional Budget Office predict that 80 percent of the revenue raised by the Cadillac tax will be through the indirect channel of higher income and payroll taxes, rather than through excise taxes collected from insurers. Simulations suggest the excise tax will have the largest relative impact on after-tax income of families in the middle income quintile.

EFFECTIVELY LIMITS THE ESI EXCLUSION

Employer-provided health benefits are excluded from taxable income, reducing in-come and payroll tax revenue by an estimated $260 billion in 2017. Even if one ig-nores the revenue losses, there are other undesirable aspects of the exclusion. The exclusion for employer-sponsored health insurance (ESI) is poorly targeted, as it is worth more to taxpayers in higher brackets who would be more likely to purchase insurance in the first place. Additionally, the ESI exclusions' open-ended nature may contribute to faster health care cost growth. For these reasons, analysts have often suggested limiting the ESI exclusion by including the value of health benefits beyond a certain threshold in taxable income (Congressional Budget Office 2013).

Key Elements of the U.S. Tax System

What is the Cadillac tax?

While the Cadillac tax plan is not a direct limit, it effectively curtails the ESI exclusion. If employers avoid the excise tax by shifting compensation from health benefits to taxable wages, the ultimate impact will be identical to an exclusion limit. In both cases, health benefits that exceeded the thresholds before introduction of the Cadillac tax would become subject to income and payroll taxes. If employers continue to offer high cost health plans, the impact will be similar to an exclusion limit—though less progressive. Excess benefits would be taxed at a 40 percent rate rather than an individual worker's marginal tax rate.[1]

[1] After accounting for income and payroll tax offsets, the effective excise tax rate is ultimately lower than 0.4 and in fact declines with income.

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Q. What changes did the Affordable Care Act make?

A. The Affordable Care Act made several changes to the tax code intended to increase health insurance coverage, reduce health care costs, and finance health care reform.

The Affordable Care Act (ACA) made several changes to the tax code intended to increase health insurance coverage, reduce health care costs, and finance health care reform. To increase health insurance coverage, the ACA provided a tax credit for individuals and small employers to purchase insurance and imposed excise taxes on individuals without adequate coverage and on employers who do not offer adequate coverage. To reduce health care costs and raise revenue for insurance expansion, the ACA imposed an excise tax on high-cost health plans. To raise additional revenue for reform, the ACA imposed surtaxes on high-income families and excise taxes on health insurers, pharmaceutical companies, and manufacturers of medical devices.

TABLE 1

Estimated Effect of ACA Tax Provisions on Federal Deficit

FY 2020

Source	$ billions
Premium Tax Credit[a b]	36
Small business health insurance credit	1
Excise taxes	-45
Inadequate health insurance coverage by individua	-3
Inadequate health insurance coverage by employe	-20
High cost health plans[c]	-3
Health insurance providers, pharmaceuticals, and medical devices	-19
High income surtaxes	-35
Additional limitation on medical expense deduction	-3
Total	-46

Source: Congressional Budget Office (2015, 2016, and 2017), Urban Institute's Health Insurance Policy Simulation Model (HIPSM), and Urban-Brooking Tax Policy Center Microsimulation Model (version 0516-2).

(a) PTC estimate from HIPSM. CBO projects the PTC will grow faster over time than HIPSM. CBO projects the impact of the PTC on the deficit will be $65 billion in FY2020.

(b) PTC estimate includes impact on revenues and outlays.

(c) Annual revenue from the excise tax on high-cost health plans is projected to grow rapidly, reaching $20 billion by 2026.

Key Elements of the U.S. Tax System

What changes did the Affordable Care Act make?

As shown in table 1, ACA tax provisions include the following:

- A refundable tax credit for families to purchase health insurance through state and federal exchanges. Tax filers must have incomes between 100 and 400 percent of the federal poverty level, be ineligible for health coverage from other sources, and be legal residents of the United States. The premium credit is projected to cost $70 billion in 2020.
- A tax credit for small employers to purchase health insurance for their workers. Employers must have fewer than 25 workers whose average wages are less than $50,000. Employers can only receive the credit for up to two years. The small-employer health insurance credit is projected to cost $1 billion in 2020.
- An excise tax on individuals without adequate health insurance coverage. Many individuals are exempt from the excise tax, including those with incomes low enough that they are not required to file a tax return, those whose premiums would exceed a specified percentage of income, and unauthorized immigrants. The excise tax is projected to raise $4 billion in 2020.
    - Try our ACA tax calculator to see how big the penalty would be.
- An excise tax on employers offering inadequate health insurance coverage. The tax applies to employers with 50 or more full-time equivalent employees. The excise tax is projected to raise $16 billion in 2020.
- An excise tax on employer-sponsored health benefits whose value exceeds specified thresholds. The thresholds are only indexed to price inflation, so more plans will be affected over time as health care costs grow faster than general inflation. The excise tax on high-cost health plans is projected to raise $7 billion in 2020 with the revenue gain growing rapidly over time, reaching $21 billion by 2025.
- An additional 0.9 percent payroll tax on earnings and a 3.8 percent tax on net investment income for individuals with incomes exceeding $200,000 and couples with incomes exceeding $250,000. The high-income surtaxes are projected to raise $35 billion in 2020.
- Excise taxes on health insurance providers, pharmaceutical manufacturers and importers, and medical device manufacturers and importers. These excise taxes are projected to raise $19 billion in 2020.

Data Sources

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Congressional Budget Office. 2015. "Budgetary and Economic Effects of Repealing the Affordable Care Act." Report, June 19. Washington, DC: Congressional Budget Office.

Q. How do health savings accounts (HSAs) work?

A. HSAs are tax-exempt savings accounts used in conjunction with a high-deductible health insurance plan (HDHP) to pay for qualifying medical expenses.

Individuals who participate in a qualifying HDHP can establish an HSA to pay for qualifying medical expenses. Both employees and employers can make contributions to an HSA.

HSAs have many tax advantages. Contributions made by employers are exempt from federal income and payroll taxes, and account owners can deduct any contributions they make from income subject to federal income taxes. Further, any income earned on the funds in an HSA accrues tax-free, and withdrawals for qualifying medical expenses are not taxed. Withdrawals used for nonqualifying expenses are subject to income tax and an additional 20 percent penalty, but the penalty is waived for account holders who are disabled, who are age 65 or over, or who have died. Unused balances can be carried over from year to year without limit.

Annual HSA contributions are limited to $3,400 for an individual and $6,750 for a family in 2017. Account holders age 55 or older can contribute an additional $1,000 to either type of account. The contribution limits are indexed annually for inflation.

In 2014, employers contributed $15.6 billion to HSAs, and individual tax filers contributed another $4.4 billion. The US Department of the Treasury estimates the tax preference for HSAs reduced income and payroll taxes by $7 billion in 2014.

Employers must offer an HSA-qualified insurance plan—usually an HDHP—for an employee to be eligible for an HSA. Individuals may also purchase an HSA-qualified insurance plan through the individual insurance market to become eligible. A plan is HSA-qualified if it meets certain requirements; in 2017, those requirements include a minimum deductible of $1,300 for individual coverage and $2,600 for family coverage.

Key Elements of the U.S. Tax System

How do health savings accounts (HSAs) work?

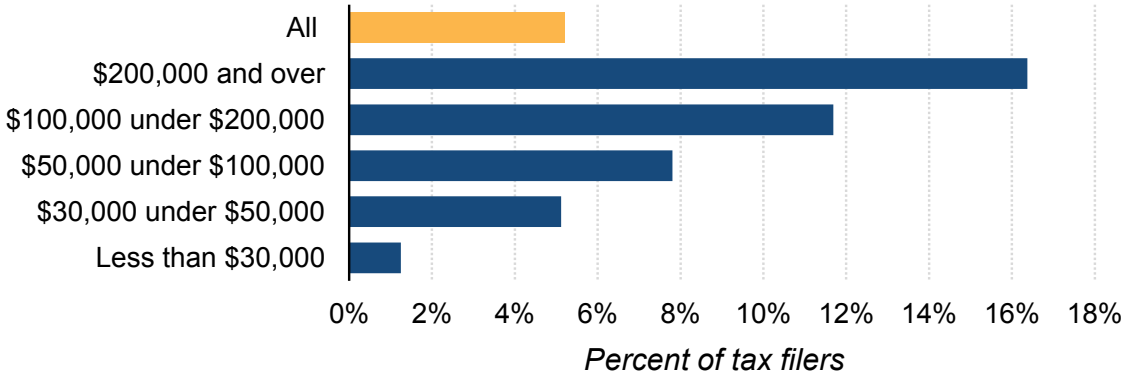
The Medicare Prescription Drug, Improvement, and Modernization Act authorized HSAs in 2003 to address the rising cost of medical care and the increasing number of uninsured individuals. HSAs are an expanded version of medical savings accounts (MSAs). MSAs also require account holders to have an HDHP and have many of the same tax advantages as HSAs. They are limited, however, to the self-employed or workers in small firms (50 or fewer employees). MSAs were established in 1996, but no new contributions to MSAs could be made after 2007, except for individuals who previously made contributions to an MSA or who work for employers that had already established MSAs.

HSAs and their associated HDHP plans place more of the health care financing burden on out-of-pocket costs and are intended to encourage more cost-conscious spending by health-care consumers. In practice, HSAs accounts are most attractive to higher-income individuals because the value of the tax exemptions associated with HSA contributions, account earnings, and withdrawals are greater for individuals in higher income-tax brackets. Additionally, high-wage workers are more likely to be constrained by contribution limits for retirement account and use HSAs as an additional means of tax-preferred saving.

In 2014, 11.7 percent of taxpayers with income between $100,000 and $200,000 contributed to an HSA, as did 16.4 percent of taxpayers with income over $200,000 (figure 1). In comparison, only 5.1 percent of taxpayers with income between $30,000 and $50,000 made such contributions. The average contribution for taxpayers with income over $200,000 was $4,716, compared with an average contribution of $1,500 for taxpayers with income between $30,000 and $50,000 (figure 2).

FIGURE 1

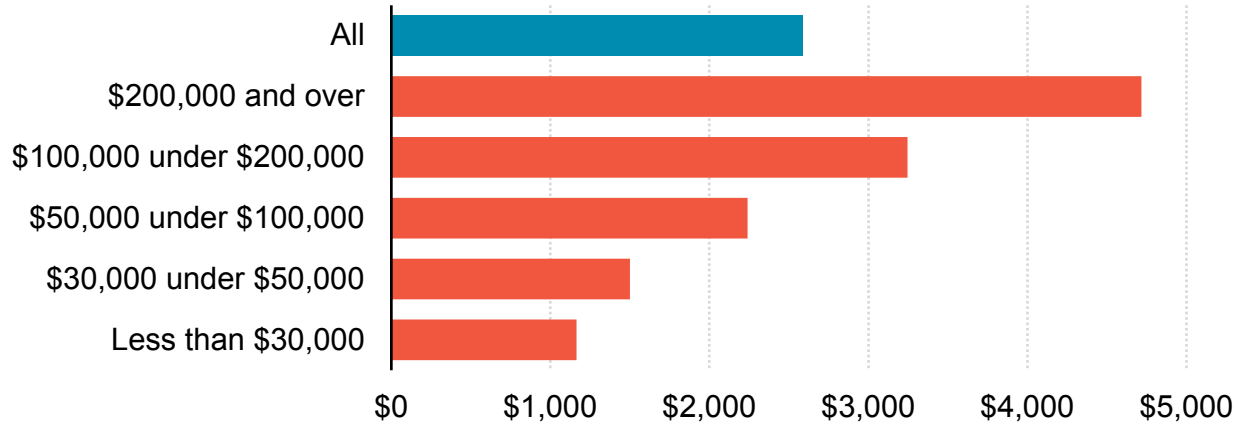
Percent of Tax Return Filers with HSA contributions by Adjusted Gross Income, 2014



Source: United States Department of the Treasury, Office of Tax Analysis, "Health Savings Accounts, 2014," at Office of Tax Analysis Resource Center, https://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Analysis-and-Research.aspx; IRS Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items," at SOI Tax Stats, https://www.irs.gov/uac/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report; author calculations.
Note: Includes both individual and employer contributions.

FIGURE 2

Average HSA Contribution by Adjusted Gross Income, 2014



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Note: Includes both individual and employer contributions.

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Q. How do flexible spending accounts (FSAs) for health care expenses work?

A. A health care FSA is an employer-sponsored account used to reimburse employees for qualifying health care expenses.

Health care FSAs are benefit plans established by an employer to reimburse employees for qualified health care expenses, such as copayments and certain prescription drug costs. FSAs are usually funded through salary reduction agreements in which the employee agrees to receive lower monetary compensation in exchange for equivalent contributions to an FSA. For example, an employee who elects to reduce his or her monthly paycheck by $200 would receive, in return, a $2,400 annual contribution to his or her FSA.

The key benefit of FSAs is that these contributions are not subject to income or employment taxes, which could mean significant tax savings for the account holder. An employee contributing $200 a month to an FSA would save $360 in federal income taxes if he or she were in the 15 percent tax bracket ($2,400 × 0.15 = $360) and an additional $184 dollars from reduced Social Security and Medicare payroll taxes ($2,400 × 0.765 = $183.60). Because the federal income tax savings depend upon the employee's income tax rate (which rises with income), the benefit of using an FSA is greater for higher-income workers. For example, the income tax savings for an employee in the 35 percent tax bracket with the same $2,400 annual contribution would be $840 ($2,400 × 0.35 = $840).

An important attribute of FSAs is that the entire value of an employee's FSA account must be made available at the beginning of the year. For example, if the same employee discussed above incurred a $3,000 medical expense in March, he or she could use the full $2,400 annual FSA contribution to help pay for that cost, even though only $600 would have been contributed into the account by March.

In 2013, the Internal Revenue Service (IRS) instituted a contribution limit for health care FSAs. The limit is adjusted yearly for inflation; in 2017, it is $2,600 per year per employer. Generally, employees must use the money in a FSA within the plan year, although employers may also offer one of two options:

- Provide a grace period of up to 2.5 months into a new plan year to use FSA money from the preceding plan year.
- Allow the employee to carry over up to $500 per plan year to use in the new plan year.

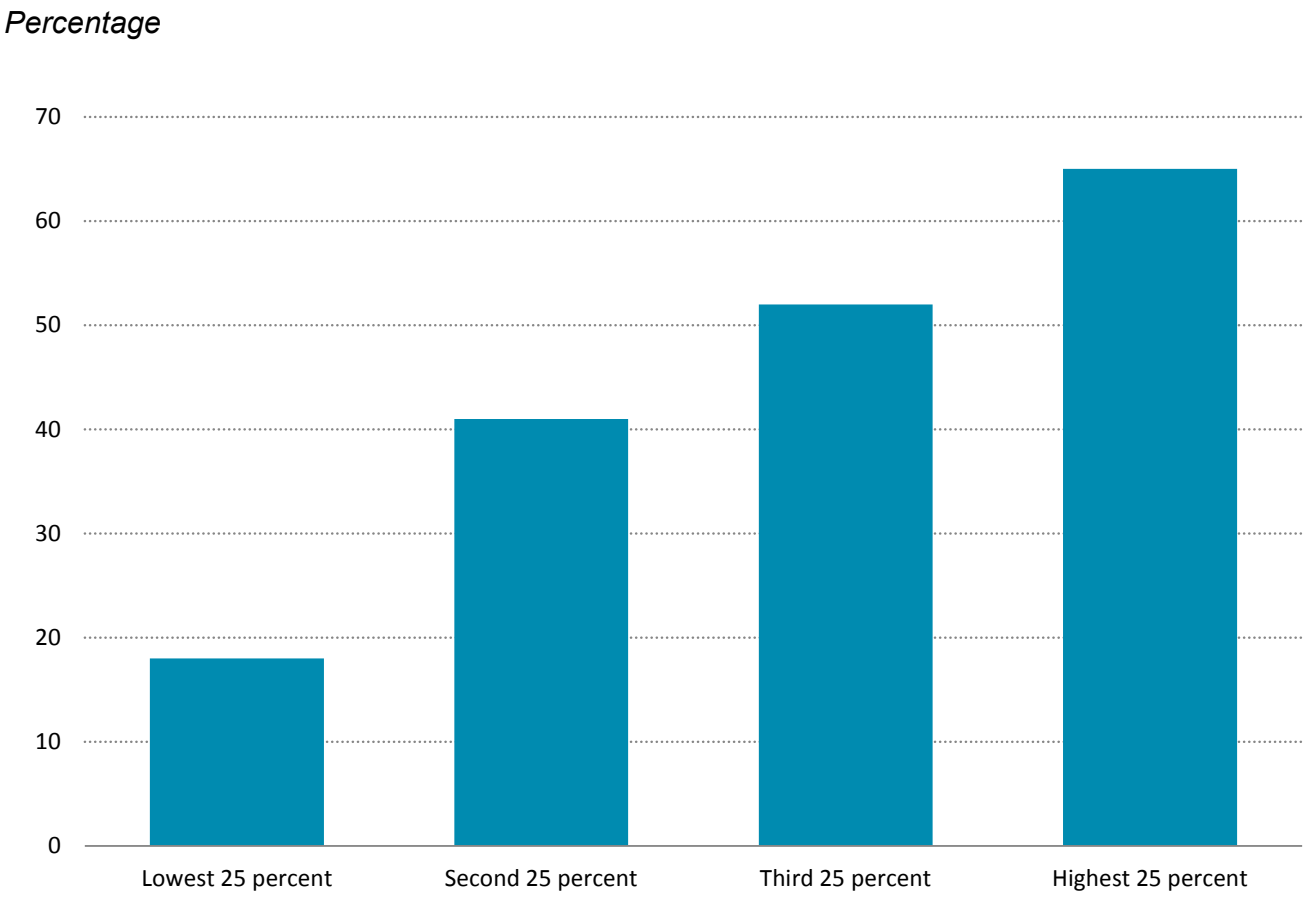
How do flexible spending accounts (FSAs) for health care expenses work?

The Bureau of Labor Statistics estimates that about 43 percent of all civilian workers had access to an FSA in 2016 (Bureau of Labor Statistics 2016, 2785). As a whole, high-income employees and employees in larger firms are more likely to have access. Only about 1 in 10 low-income workers had access to a FSA in 2015 compared with about 7 in 10 workers at the top of the earning scale (figure 1).

FIGURE 1

Percentage of Workers with Access to Health Care FSAs, 2016

By wage percentile



Source: Table 41 of National Compensation Survey: Employee Benefits in the United States, March 2016 (Bureau of Labor Statistics 2016, 2785).

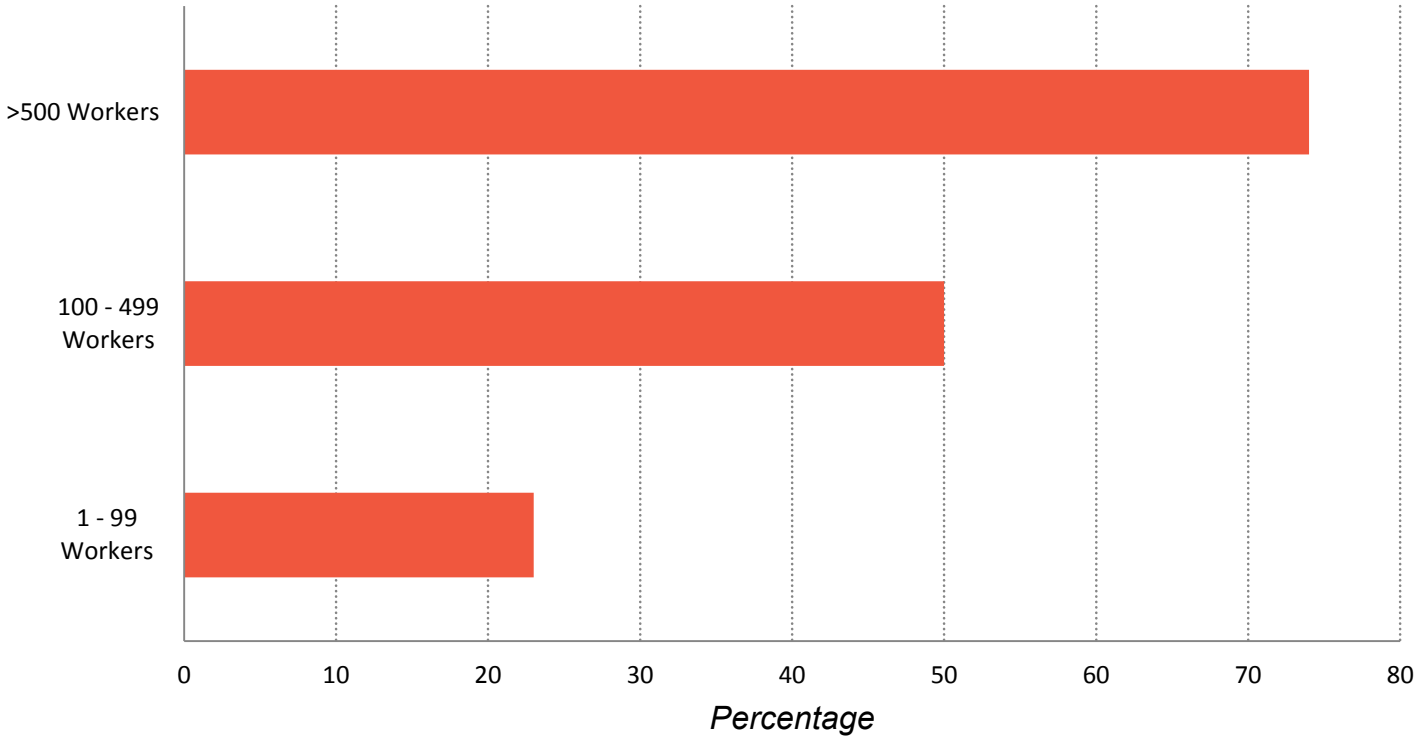
How do flexible spending accounts (FSAs) for health care expenses work?

Employees in larger firms (500 or more workers) are about three times as likely to have access than employees in smaller firms (99 or fewer workers), with 74 percent of the former reporting access versus 23 percent of the latter in 2016 (figure 2). Larger firms are typically better able to handle the complexity and administrative costs of offering FSAs, and low-income jobs often do not offer health insurance, thus eliminating access to flexible benefits, such as FSAs, for such workers.[3]

FIGURE 2

Percentage of Workers with Access to Health Care FSAs, 2016

By firm size



Source: Table 41 of National Compensation Survey: Employee Benefits in the United States, March 2016 (Bureau of Labor Statistics 2016, 2785).

[1]Allowable expenses are discussed in the IRS publication Medical and Dental Expenses (IRS 2016).
[2]Contributions to a FSA also are not subject to the employer portion of payroll taxes. The $2,400 reduction in the employee's earnings credited to his or her Social Security accounted could slightly reduce the employee's eventual Social Security benefit.
[3]Only individuals eligible for employer-provided major medical coverage can be offered the FSA. The IRS stipulated this new restriction in 2013 with Notice 2013-54.

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Q. How do health reimbursement accounts (HRAs) work?

A. HRAs are employer-sponsored accounts, funded solely by employers, used to reimburse employees for qualified medical expenses.

HRAs are established by the employer, and only the employer can contribute to the account. Although they have no contribution amount limit, the employer does set a self-designated annual contribution amount. Employers can also restrict the types of medical services that are eligible for reimbursement from the list of qualified services defined by the Internal Revenue Service.

Reimbursements for qualified medical expenses are exempt from federal income and payroll taxes. Any unused funds can carry over indefinitely, although employers may limit the aggregate carryover amount.

Employers need not fund HRAs until employees draw on the funds and, unlike flexible spending accounts, the entirety of the funds do not need to be available from the beginning of the period. HRAs are usually offered in conjunction with a high-deductible health plan, although employers can "integrate" them with other types of qualified group health plans. With the implementation of the Affordable Care Act in 2010, specifically the addition of Section 2711 of the Public Health Service Act, which prohibits group health insurance plans from limiting the dollar value of lifetime and annual "essential health benefits," most HRAs are no longer available as stand-alone accounts, although there are a few exceptions. HRAs, by definition, impose an annual benefit limit as the employer contributes a preset amount every year.

[1]Retiree HRAs and one-person stand-alone HRAs are still compliant with the new ACA ruling.

Data Sources

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Q. What are the tax benefits of homeownership?

A. The main tax benefit of owning a house is that the imputed rental income homeowners receive is not taxed. Although that income is not taxed, homeowners still may deduct mortgage interest and property tax payments as well as certain other expenses from their federal taxable income. Additionally, homeowners may exclude, up to a limit, the capital gain they realize from the sale of a home.

OVERVIEW

The tax code provides a number of benefits for people who own their homes. The main benefit is that the owners do not pay taxes on the imputed rental income from their own homes. 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. It is a form of income that is not taxed.

Homeowners may deduct both mortgage interest and property tax payments as well as certain other expenses from their federal income tax. In a well-functioning income tax, all income would be taxable and all costs of earning that income would be deductible. Thus, in a well-functioning income tax, there should be deductions for mortgage interest and property taxes. However, our current system does not tax the imputed rental income that homeowners receive, so the justification for giving a deduction for the costs of earning that income is not clear.

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.

MORTGAGE INTEREST DEDUCTION

Homeowners who itemize deductions may reduce their taxable income by deducting any interest paid on a home mortgage. The deduction is limited to interest paid on up to $1 million of debt incurred to purchase or substantially rehabilitate a home. Homeowners also may 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.

Key Elements of the U.S. Tax System

What are the tax benefits of homeownership?

The Tax Policy Center (TPC) estimates that 20 percent of all tax units will benefit from the deduction in 2015. The congressional Joint Committee on Taxation (JCT) estimated that the mortgage interest deduction will cost the federal government almost $75 billion in lost revenue in fiscal year 2015.

PROPERTY TAX DEDUCTION

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 jurisdictions 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 estimated that the deduction saved millions of homeowners a total of $34 billion in income tax in fiscal year 2015.

IMPUTED RENT

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"—is 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 $79 billion in fiscal year 2015.

PROFITS FROM HOME SALES

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 they generally may not have claimed the capital gains exclusion for the sale of another home during the previous two years. The JCT estimated that the exclusion provision saved homeowners more than $27 billion in income tax in fiscal 2015.

EFFECT OF DEDUCTIONS AND EXCLUSIONS

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 39.6 percent top tax bracket $792, but saves a taxpayer in the 15 percent bracket only $300. Additionally, even though they only represent about 20 percent of all tax units, those with more than $100,000 in income receive over 85 percent of the mortgage interest deduction tax benefits. That difference results largely 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.

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Q. Do existing tax incentives increase homeownership?

A. Probably not. The US homeownership rate is lower than in many other developed countries such as the United Kingdom or Australia, which do not offer tax subsidies for homeownership, and even lower than some other countries with subsidies. Beyond a base level, US subsidies mainly support larger homes and second homes. Additionally, evidence suggests that the subsidies raise housing costs, thus dissipating their effectiveness in helping people buy their own homes.

Contrary to popular belief, the mortgage interest deduction was not added to the tax code to encourage home ownership. The deduction existed at the birth of the income tax in 1913—a tax explicitly designed to hit only the richest individuals, a group for whom homeownership rates were not a social concern.

The federal government now provides more than $120 billion each year in tax benefits to subsidize homeownership, yet our rate of homeownership differs little from that in countries providing no similar subsidies. The bulk of US subsidies go to middle- and upper-income households that likely would 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 US homeownership rate is lower than that in many other developed countries such as the United Kingdom or Australia that have no such subsidies. The rate is even lower than some in countries that have subsidies, such as Sweden and Norway (figure 1). Other factors, including 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, which face the highest tax rates, the deductibility of property taxes and mortgage interest most helps households that would likely own their own homes even without a tax subsidy. Low-income households, which 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.

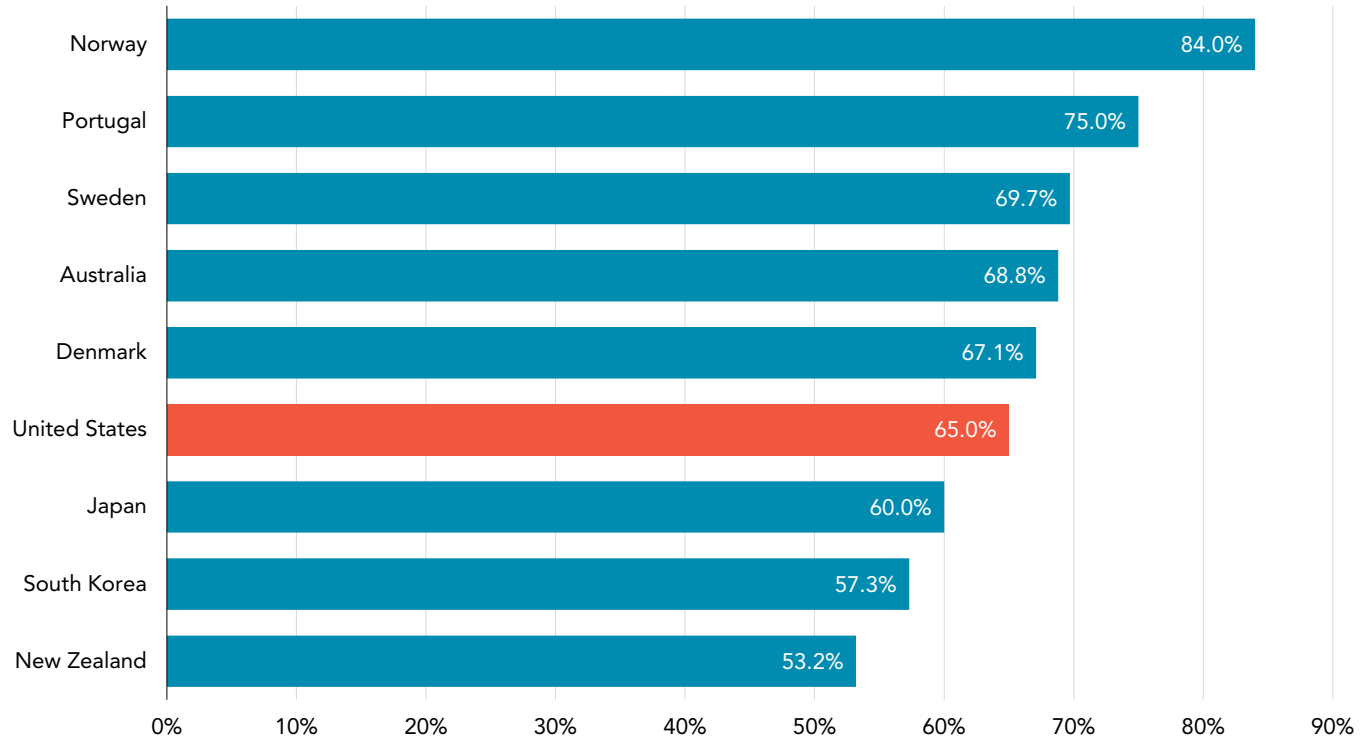
Key Elements of the U.S. Tax System

Do existing tax incentives increase homeownership?

FIGURE 1

Homeownshership Rates in Select Countries

Share of adults who own their homes



Source: Desilver, 2013.

Research suggests that housing subsidies raise housing costs, particularly where land is 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 rise most in markets where supply cannot easily increase to meet that higher demand.

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Key Elements of the U.S. Tax System

Q. Why are taxes so complicated?

A. Our tax system could be simple if its only purpose were to raise revenue. But it has other goals, including fairness, efficiency, and enforceability. And Congress has used the tax system to influence social policy as well as to deliver benefits for specific groups and industries.

Almost everyone agrees that the current tax system is too complicated, yet almost every year the system gets more complex, not less. Why? Tax simplicity almost always conflicts with other policy goals.

For example, the simplest—and least distorting—tax is a head tax, a fixed dollar tax on everyone. But a head tax would be unfair, taking no account of differences in the incomes and needs of individuals, families, and businesses.

COMPETING GOALS FOR A TAX SYSTEM

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 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 expenditures or income, have to be reported and documented. These conflicting objectives appear to be especially relevant in the current tax code, where desires to channel tax cuts to particular groups have added significant complexity.

POLITICS OF TAX POLICY

Politics compounds complexity. Interest groups—and thus politicians—support tax subsidies for particular groups or activities. And these targeted subsidies inevitably complicate the tax system by creating distinctions among taxpayers, and among sources and uses of income.

Moreover, bowing to pressure from a handful of antitax activists, many members of Congress have signed a pledge to never raise taxes. That promise makes it difficult to get rid of tax preferences that lower taxes for some taxpayers but complicate the tax system. Honoring the pledge means that any simplification that raises taxes must be offset with another change that lowers them. Meeting that goal can often mean further complicating the tax system.

Key Elements of the U.S. Tax System

Why are taxes so complicated?

OTHER GOALS

Some complexity is necessary to deter tax avoidance. Taxpayers, of course, have the 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 adapt to skirt the new rules. This can create a vicious cycle that leads to more complicated rules and increasingly complex avoidance strategies beloved by high-priced accountants and lawyers.

Many complicated provisions were enacted to raise revenue or to limit revenue losses during times of rampant budget deficits. For example, the landmark Tax Reform Act of 1986—a remarkable accomplishment in many respects—gave up some simplifying changes to meet the goal of revenue neutrality. The act created several complicated phaseouts and hidden taxes to meet revenue and distributional targets.

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Q. How costly is complexity?

A. Tax compliance imposes three major costs: taxpayers' time spent filing returns; their out-of-pocket costs of keeping records, hiring preparers, buying software, and the like; and government costs of administering the tax system. All of those costs increase with the complexity of the tax system, but their magnitudes are difficult to measure.

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 costs of the current tax system requires dividing compliance costs into several components: the value of the time taken to comply with system requirements; the out-of-pocket costs 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. Most find that the average taxpayer devotes little time to paying taxes, but that a small subset (many of them high-income and self-employed individuals) devotes much more.

COSTS OF FILING TAXES

In a 2013 study, IRS and Treasury analysts estimated that taxpayers spent 1.8 billion hours and $28.3 billion preparing and filing individual income taxes in 2010. These figures correspond to an average of 12.5 hours and $198 per taxpayer. But the numbers varied considerably by taxpayer income and complexity of the tax return. For example, taxpayers with adjusted gross incomes under $30,000 spent an average of about 10 hours and just over $110 preparing their returns, compared with about 14.5 hours and $328 for those with adjusted gross income between $100,000 and $200,000.

Compliance costs vary with the forms needed to file tax returns—simpler forms take less time to complete and require less information. In 2013, 43 percent of taxpayers filed a simplified version of the standard 1040 form, either the 1040A or the 1040EZ. In this group, nearly half did not itemize deductions, less than one-fourth claimed capital gains or losses, and nearly three-fourths had no business income—all factors that complicate tax filing.

Key Elements of the U.S. Tax System

How costly is complexity?

Information on the use of paid preparers gives further hints about how complex taxpayers find the system to be. In 2013, 56 percent of tax filers used paid preparers. Among those who filed the 1040, 62 percent used preparers. Even among 1040A and 1040EZ filers, 46 percent used preparers. It is unclear, however, whether these figures indicate that tax filers are using paid preparers because they cannot navigate the tax code themselves, or whether they simply dislike the paperwork enough to pay others to do the work for them.

The IRS currently uses models from Arthur D. Little consultants 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 2010, the Office of Management and Budget estimated that taxpayers needed 2.4 billion hours to comply with the requirements of all tax forms and IRS regulations (Office of Information and Regulatory Affairs 2011). This estimate applied to both businesses and individuals, and included all federal taxes, not just income taxes.

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Q. What are the benefits of simpler taxes?

A. Simpler taxes have lower compliance costs—in terms of both time and money—and may encourage taxpayers to use tax provisions aimed at helping people pay for socially desirable activities.

Simplification could improve the tax code in at least two important ways. First, simplicity would lower taxpayers' costs of complying with the tax system in terms of time, money, and mental anguish. Second, simpler tax provisions are more likely to be used. Provisions aimed at encouraging specific activities, such as saving for college, would be more effective if people understood how they work.

Making taxes simpler could raise compliance rates by reducing inadvertent nonpayment of taxes. To some (uncertain) extent, people do not pay taxes because they do not understand the tax law. Evidence also suggests that people are more likely to evade taxes they consider unfair. People who cannot understand tax rules may question the fairness of the tax system and feel that others are reaping more benefits than they are.
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Q. What policy reforms could simplify the tax code?

A. Reducing the number of distinctions among economic activities and taxpayers' personal characteristics would simplify the code, reducing both compliance costs for taxpayers and administrative costs for the government. The consequent broadening of the tax base would allow lower tax rates while maintaining revenue and also reduce economic distortions caused by taxation.

The key to tax simplification is to make fewer distinctions across economic activities and taxpayers' personal characteristics. This would not only reduce compliance costs, but allow for simpler administration. For example, if everyone paid the same tax rate on dividends, the tax could be collected from dividend payers without having to trace who got what.

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 do now), a basic exemption amount, and the choice of tax base (income, consumption, or another measure), rather than through specific provisions that treat different levels of income and consumption differently. Universal exemptions, deductions, or credits are much simpler to administer than targeted ones.

Several fairly modest changes could make the current tax system simpler as well as fairer and more conducive to economic growth. One possible focus: the individual alternative minimum tax (AMT). To spare middle-income taxpayers who were never its target, the AMT should allow deductions for dependents and for state and local taxes. Further, all personal credits should be available against the AMT. Any new proposal that cuts regular income tax liabilities should also make conforming adjustments to the AMT so that more taxpayers are not subjected to it.

Another option would coordinate the phaseout of tax credits. Specific tax credits phase out across different income ranges, so that claiming each credit requires a separate worksheet and tax calculation. The phaseouts also create hidden taxes over the phaseout range and diminish the effectiveness of the credits by encouraging the very activities they are designed to spur.

Key Elements of the U.S. Tax System

What policy reforms could simplify the tax code?

Numerous provisions—each with its own rules—apply to the same general activity. Coordinating or consolidating these provisions could simplify taxes with little or no change in revenue or the distribution of taxes. Examples include the various provisions related to families with children (the earned income tax credit, the dependent exemption, and the child credit), tax subsidies for education (the American Opportunity and Lifetime Learning credits, and the deductibility of tuition and fees), and saving incentives (traditional individual retirement accounts, Roth IRAs, education IRAs, and Keogh plans).

Yet another simplification would tax capital gains as ordinary income in return for a reduction in top tax rates. This was the cornerstone of the 1986 deal that allowed substantial simplification of the individual income tax. Returning to this approach would massively reduce incentives to create tax shelters or to engage in complex tax planning.

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Q. How do the estate, gift, and generation-skipping transfer taxes work?

A. The federal estate tax applies to the transfer of property at death. The gift tax applies to transfers made while a person is living. The generation-skipping transfer tax is an additional tax on a transfer of property that skips a generation.

The United States has taxed the estates of deceased people 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 effect that year.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate and GST taxes for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent, but allowed executors to elect the EGTRRA rules for decedents who died in 2010. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012, but the top rate was increased to 40 percent.

Here's how the gift tax works:

- Congress enacted the gift tax in 1932 to prevent donors from avoiding the estate tax by transferring their wealth before they died.
- The tax provides a lifetime exemption of $5.49 million per donor in 2017. This exemption is the same that applies to the estate tax and is integrated with it (i.e., gifts reduce the exemption amount available for estate tax purposes). Beyond that exemption, donors pay gift tax at the same top rate (40 percent) that applies for estate tax purposes.
- An additional amount each year is also exempted from both the gift tax and the lifetime exemption. This exemption, $14,000 in 2017, is indexed for inflation in $1,000 increments and is granted separately for each recipient. Thus, a married couple with three children could give their children a total of $84,000 each year ($14,000 from each parent to each child) without owing tax or counting toward the lifetime exemption.
- Regardless of size, gifts received are not taxable income to the recipient.

Key Elements of the U.S. Tax System

How do to estate, gift, and generation-skipping transfer taxes work?

Here's how the estate tax works:

- 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 ($5.49 million in 2017; table 1).
- The estate tax applies to a decedent's gross estate, which generally includes all the decedent's assets, both financial (e.g., stocks, bonds, and mutual funds) and real (e.g., homes, land, and other tangible property). It also includes the decedent's 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, charitable bequests, 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 2017, the effective exemption is $5.49 million. Any value of the estate over $5.49 million is generally taxed at the top rate of 40 percent.
- Although tax rates are graduated, all transfers in excess of the exemption are taxed at the top rate because the exemption exceeds the threshold at which the top rate applies.
- Special provisions reduce the tax, or spread payments over time, for family-owned farms and closely-held businesses. 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 14 years at reduced interest rates, with only interest due during the first five years.
- Regardless of size, inheritances are not taxable income to the recipient.

And here's how the generation-skipping trust tax works:

- 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. 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.

Key Elements of the U.S. Tax System

How do to estate, gift, and generation-skipping transfer taxes work?

TABLE 1

Estate, Gift, and GST Tax Rates and Exemptions under Current Law

2007-2017

Year	Estate and GST tax rate	Gift tax rate	Estate and GST tax exemptions	Lifetime gift exemptions	Annual gift exemptions
2007	45%	45%	$2 million	$1 million	$12,000
2008	45%	45%	$2 million	$1 million	$12,000
2009	45%	45%	$3.5 million	$1 million	$13,000
2010	0%[a]	35%	N/A[b]	$1 million	$13,000
2011	35%	35%	$5 million	$5 million	$13,000
2012	35%	35%	$5.12 million	$5.12 million	$13,000
2013	40%	40%	$5.25 million	$5.25 million	$14,000
2014	40%	40%	$5.34 million	$5.34 million	$14,000
2015	40%	40%	$5.43 million	$5.43 million	$14,000
2016	40%	40%	$5.45 million	$5.45 million	$14,000
2017	40%	40%	$5.49 million	$5.49 million	$14,000

Source: Internal Revenue Code.

(a) The exemption, which was $10,000 in 1998, is indexed for inflation in $1,000.

(b) Executors can elect to apply the EGGTRA rules, which repealed the estate tax for 2010, but otherwise the 2011 parameters apply.

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Q. Who pays the estate tax?

A. The top 10 percent of income earners pays over 90 percent of the tax, with over one-fourth paid by the richest 0.1 percent. Very few farms or family businesses pay the tax.

TABLE 1

Number of Estate Taxpayers and Distribution of Estate Tax Burden
2017 current law[a]

Source	Expanded Cash Income Category					Businesses and Farms	
	All	Top 10 percent	Top 5 percent	Top 1 percent	Top 0.1 percent	All[b]	Small[c]
Number of returns[d]	11,020	8,430	7,270	3,490	530	1,010	270
Number taxable[d]	5,190	3,600	2,890	1,360	220	370	50
Percent of all taxable returns	100	69	56	26	4	7	1
Estate tax paid ($ millions)[e]	19,680	17,720	16,370	12,310	5,260	2,040	20
Percent of all estate tax paid	100	90	83	63	27	10	0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1)
(1) Estimates are for estate tax returns filed for individuals who die in 2017.
(2) Estate tax returns on which farm and business assets represent at least half of gross estate.
(3) 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.
(4) Number of returns is rounded to nearest multiple of ten.
(5) Estate tax paid is rounded to nearest multiple of ten million.

The Tax Policy Center estimates that some 11,020 individuals dying in 2017 will leave estates large enough to require filing an estate tax return (estates with a gross value under $5.49 million need not file this return in 2017). After allowing for deductions and credits, 5,190 estates will owe tax. Nearly 70 percent of these taxable estates will come from the top 10 percent of income earners and over 25 percent will come from the top 1 percent alone.

Estate tax liability will total an estimated $19.7 billion in 2017. The top 10 percent of income earners will pay 90 percent of this total. The richest 0.1 percent will pay $5.3 billion, or 27 percent of the total.

Only an estimated 50 small farms and closely held businesses—estates with farm and business assets totaling

no more than $5 million and making up at least half of gross estate—will pay any estate tax in 2017. Such estates will represent only 1 percent of all taxable estate tax returns.

The Tax Policy Center estimates that small farms and businesses will pay $20 million in estate tax in 2017, one-tenth of 1 percentage of the total estate tax revenue.

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Q. How many people pay the estate tax?

A. About 9,500 estate tax returns were filed for people who died in 2011, of which only 4,400 were taxable, less than 1 in 500 of the 2.5 million people who died in that year.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) raised the estate tax exemption from $675,000 in 2001 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. EGTRRA repealed the estate tax for 2010, but after that, the estate tax was scheduled to revert to pre-EGTRRA rules.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax and generation-skipping transfer tax (GST) and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012, but the top rate was increased to 40 percent.

- IRS data show that roughly 109,500 estate tax returns were filed for decedents in 2001, the year before the EGTRRA changes began to go into effect. Fewer than half—about 50,500—of those estates had any estate tax liability after credits. Estate tax liability totaled $23.7 billion.
- For decedents in 2009, the year the final increase in the estate tax exemption under EGTRRA went into effect, only about 12,900 estate tax returns were filed, of which only 5,700 were taxable. Estate tax liability totaled $13.6 billion.
- For those who died in 2010, executors could elect to have the EGTRRA rules apply, which meant that no estate tax was imposed on the estate. However, instead of a full step-up in basis for recipients of bequests, their step-up was limited to $1.3 million (plus an additional $3 million for surviving spouses) with any additional unrealized gains required to be carried over. So some deferred tax on these additional unrealized gains will be paid by recipients of bequests under the income tax.
- For decedents in 2017 (with an exemption of $5.49 million), the Tax Policy Center estimates there will be only about 11,000 estate tax returns filed, of which 5,200 will be taxable. Estate tax liability will total $19.7 billion after credits (table 1).
- To put the number of estate tax returns filed in perspective, the Population Division of the Bureau of the Census projects that 2.7 million people will die in 2017. Thus, an estate tax return will be filed for only 1 in 243 decedents, and only 1 in 517 will pay any estate tax.

Key Elements of the U.S. Tax System

How many people pay the estate tax?

TABLE 1
Estimated Estate Tax Returns and Liability
2001, 2007-2017

	2001	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Estate tax returns	109,600	36,700	29,000	12,900	[2]	9,500	9,900	10,800	10,800	10,800	10,900	11,000
Taxable returns	50,500	16,600	15,100	5,700	[2]	4,400	4,200	5,300	5,300	5,300	5,200	5,200
Estate tax liability ($ millions)	23,700	24,600	18,900	13,600	[2]	10,900	12,400	17,500	17,900	18,400	19,000	19,700

Source: For 2001, 2009 and 2011: Internal Revenue Service, Statistic of Income (SOI) Division of IRS; for 2012-17, the Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
(1) Figures are for estate tax returns filed for decedents dying in each calendar year.
(2) The estate tax was repealed for 2010 decedents by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), but reinstated by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 with an option for executors to elect the EGTRRA rules. SOI has not published statistics for 2010 decedents.

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Q. What is the difference between carryover basis and a step-up in basis?

A. The difference is whether heirs who sell an inherited asset will pay tax on the capital gains from the time the asset was originally purchased or from the time they inherited it. In some cases, the difference is a lot of tax liability.

A capital gain occurs if a capital asset is sold or exchanged at a price higher than its "basis," the original purchase price with some adjustments. When a person inherits an asset, the basis becomes the fair market value of the asset at the time of the owner's death. This is called a "step-up in basis" because the basis of the decedent's asset is stepped up to market value. With gifts made during the giver's lifetime, the recipient retains the basis of the person who made the gift ("carryover basis").

The unrealized gain (or loss) on assets given by gift or bequest is not included in the income of the donor. The recipient is not subject to income tax on the asset's value at the time it is received, but generally must include any gain if the asset is subsequently sold or otherwise disposed of. The realized gain is the amount received from the sale of the asset less the asset's basis. For most sales, the basis is the amount the taxpayer invested in the asset, adjusted for subsequent improvements, depreciation, and certain other items. For gifts and inheritances, however, special basis rules apply.

For gifts, the basis remains the same as when the asset was held by the person who made the gift ("carryover basis"), but with an adjustment for any gift tax paid. For inheritances, the basis is the fair market value of the asset at the time of the donor's death (or six months afterward, if the alternative valuation date is elected by the executor). This is referred to as "step-up in basis" (or "stepped-up basis") because the previous basis is stepped up to market value.

The effect of carryover basis on gifts is to tax the unrealized gain accrued by the donor when the recipient sells the asset. The effect of step-up in basis on inheritances is to eliminate income tax on any unrealized gain accrued by the decedent.

Key Elements of the U.S. Tax System

What is the difference between carryover basis and a step-up in basis?

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) repealed the estate tax for 2010. But instead of allowing recipients the full step-up in basis in effect up until that year, it limited their step-up to $1.3 million (plus an additional $3 million for surviving spouses) with any additional unrealized gains carried over. Although the EGTRRA rules for 2010 were subsequently replaced, executors could elect EGTRRA treatment for 2010 decedents (and, in some cases, had a financial incentive to do so). So some deferred tax on the additional unrealized gains of decedents for whom an election was made will be paid by heirs under the income tax.

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Q. How could we reform the estate tax?

A. Possible reforms run the gamut from repeal to modest fixes that would make the tax more difficult to avoid.

Proposals to reform the estate and gift tax range from comprehensive options, such as permanently repealing the estate tax or replacing the existing tax with a tax on inheritances, to more modest options, such as decreasing exemption amounts, increasing tax rates, and blocking avenues for avoiding the tax.

The federal estate and gift taxes (including the generation-skipping tax, or GST) have changed virtually every year since 2001. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut these taxes sharply but only through 2010. EGTRRA gradually phased out the estate tax and GST, and eliminated them 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 reinstated the estate tax and GST for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent. But it allowed executors to elect the EGTRRA rules for decedents who died in 2010. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012 (ATRA), though with a new top rate of 40 percent. In light of numerous recent proposals to repeal these taxes or reform them in some manner, how "permanent" the ATRA changes are remains to be seen.

Many members of Congress have called for the repeal of the estate and gift taxes. That would be expensive, however. The Congressional Budget Office projects that these taxes will raise $250 billion in fiscal years 2017 through 2026.

Repeal would also be regressive—the benefits would go almost entirely to people at the top of the income distribution—and would invite significant sheltering of income. Further, 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. Prior estimates indicate that repealing the estate tax would reduce charitable donations by 6 to 12 percent.

One option, the substitution of an inheritance tax, would tax wealth transfers somewhat differently. 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 ef-

fective tax rate. Most countries that tax wealth transfers do so with inheritance taxes rather than estate taxes.

A more modest reform could address the loopholes, such as special trust arrangements and valuation discounts. Those tax avoidance measures complicate estate planning and result in unequal taxes on comparable estates. Closing loopholes could increase revenues, moreover, allowing a higher estate tax exemption, lower rates, or deficit reduction.

The following reforms would only change the estate tax exemption level and rates, and the treatment of wealth transfer taxes paid to states (figure 1).

- Pre-ATRA Law: The old law had an exemption level of $1 million (not indexed for inflation) and a top statutory rate of 55 percent, along with a 5 percent surtax that phased out the benefit of lower rates for large estates and a credit (rather than a deduction) for state wealth transfer taxes. Making pre-ATRA law permanent starting in 2017 would increase the number of estate tax returns filed between 2017 and 2026 by 1.5 million and increase the estate tax liabilities of these decedents by $405 billion.

- 2012 Law: The estate tax law in effect in 2012 had an exemption of $5 million (indexed for inflation from 2011) and a top rate of 35 percent, so it differs from current law only in the top rate. Making 2012 law permanent starting in 2017 would not affect the number of estate tax returns filed but would decrease estate tax liabilities by about $29 billion for decedents who died between 2017 and 2026.

- 2009 Law: The estate tax law in effect under EGTRRA for 2009 had an exemption of $3.5 million and a top rate of 45 percent. If 2009 law were made permanent starting in 2017, the number of estate tax returns filed between 2017 and 2026 would increase by 142,000, and estate tax liabilities of these decedents would increase by $131 billion.

- 2009 Law, Exemption-Indexed: If 2009 law, modified to index the exemption to inflation, were made permanent starting in 2017, the number of estate tax returns filed between 2017 and 2026 would increase by 81,000, and estate tax liabilities of these decedents would increase by $88 billion (about one-third less than the increase without indexing the exemption).

Key Elements of the U.S. Tax System

How could we reform the estate tax?

FIGURE 1

Change in Total Number of Estate Tax Returns Filed and Estate Tax Liability Under Alternative Reforms
2017-2026

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
(1) There is no change in the number of returns filed under 2012 law because the exemtpion is the same as under current law.

Data Sources

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Q. How should wealth be taxed?

A. There are three options: an estate and gift tax (like the current US federal system), an inclusion tax, or an accessions tax.

The transfer of wealth through gifts or bequests can be taxed in three ways: under an estate and gift tax (like the current US federal system), under an inclusion tax, or under an accessions tax.

ESTATE AND GIFT LEVY TAXES

An estate and gift levy taxes the donor or the donor's estate using separate estate and gift tax rate structures. Apart from transfers to spouses and charities, which are generally exempt from tax, and the small annual exemption from the gift tax, the amount of tax imposed on the transfer does not vary with the income or other characteristics of the transfer recipients.

INCLUSION TAXES

An inclusion tax requires recipients to treat transferred assets as taxable income. The amount of tax therefore varies with the recipients' characteristics (e.g., their filing status), the amount of their other income, the amount of their deductions, and other factors that affect income tax liability.

ACCESSIONS TAXES

An accessions tax, like an inclusion tax, taxes recipients on the value of transfers received, but under a rate structure different from the income tax rate structure. The amount of tax imposed on the transfer therefore depends only on the amount received by the recipient in the relevant time period.

CONSIDERATIONS

Under all three approaches, the treatment of the donor's unrealized gains is an important consideration that affects incentives to transfer and the amount of tax revenue produced. A donor's unrealized gains could be taxed as part of his or her income. Alternatively, such gains could be taxed when realized by the recipient if a carryover basis is required. On the other hand, if a step-up in basis is allowed for the recipient such gains could never be taxed at all.

How should wealth be taxed?

An important consideration for an accessions tax is the relevant time period over which transfers are taxed. If transfers are taxed annually with a graduated rate schedule, much less tax would be paid on lifetime transfers received evenly over many years than if the entire amount was received in one year. These differences could be addressed by taking into account the accumulated transfers recipients received over their lifetimes, much like the lifetime accumulation of gifts and integration with the estate tax under the current federal tax.

The taxation of lifetime transfers can also differ under an inclusion tax because of the graduated income tax rate schedule. One way to address these differences would be to allow averaging of inclusions over several years.

Under an estate and gift tax, the number of recipients doesn't affect the amount of tax paid on transfers. Taxing inheritances under an inclusion tax or an accessions tax may encourage broader transfers of wealth because broader transfers would generally reduce the total amount of tax paid.

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Joint Committee on Taxation. 2015. "History, Present Law and Analysis of the Federal Wealth Transfer System." JCX-52-15. Washington, DC: Joint Committee on Taxation.

Q. What is an inheritance tax?

A. A type of wealth transfer tax in which the recipient, rather than the donor's estate, is taxed.

An inheritance tax applies to the amount of gifts and bequests a taxpayer receives. Unlike estate and gift taxes, a progressive inheritance tax gives donors an incentive to spread their wealth more broadly because 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 wealth transfer taxes falls on recipients rather than donors; recipients receive a smaller after-tax gift or inheritance than they would without the tax. However, the burden on individual recipients varies depending on whether the tax is an inheritance tax or an estate and gift tax.

Inheritance taxes come in three principal forms. An accessions tax applies to the amount an individual receives by gift or bequest over a 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 as such. Thus, the tax rate depends on the size of the gift or bequest as well as the recipient's other income. An inclusion tax could be combined with either of the other two types of inheritance taxes into a single tax that takes advantage of the strengths of each.

Most countries rely on inheritance taxes rather than on estate and gift taxes. More than half of the 34 countries in the Organisation for Economic Co-Operation and Development have an annual inheritance tax (figure 1); a few use accessions and inclusion taxes. Only three (besides the United States) have estate taxes. The past several decades have seen a shift away from estate taxes: Australia, Canada, and New Zealand repealed their estate taxes, and Ireland replaced its estate tax with an inheritance tax.

Some analysts argue that inheritance taxes are simpler to administer than estate taxes because they 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 argue that estate taxes are simpler because they require less record keeping.

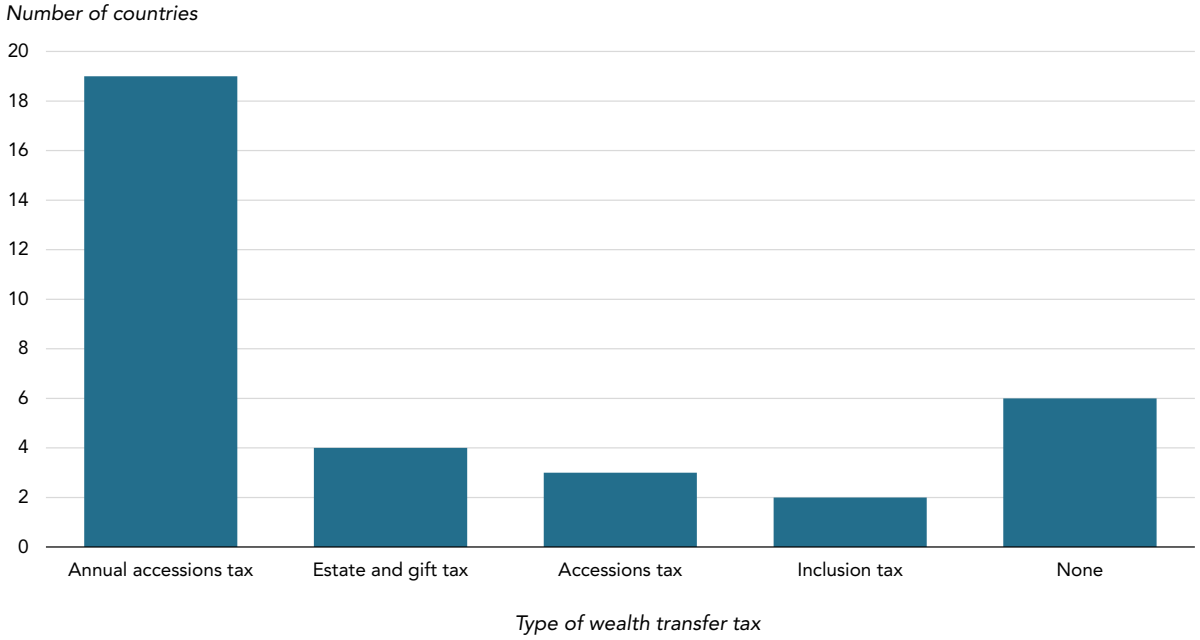
Key Elements of the U.S. Tax System

What is an inheritance tax?

FIGURE 1

Type of Wealth Transfer Tax in 34 Countries

2007



Source: Lily L. Batchelder, "How Should an Ideal Consumption Tax or Income Tax Treat Wealth?" (2007).

Data Sources

Batchelder, Lily. *How Should an Ideal Consumption Tax or Income Tax Treat Wealth Transfers?* Figure 6. "Type of Wealth Transfer Tax in 34 Countries."

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Key Elements of the U.S. Tax System

What are the major federal payroll taxes, and how much money do they raise?

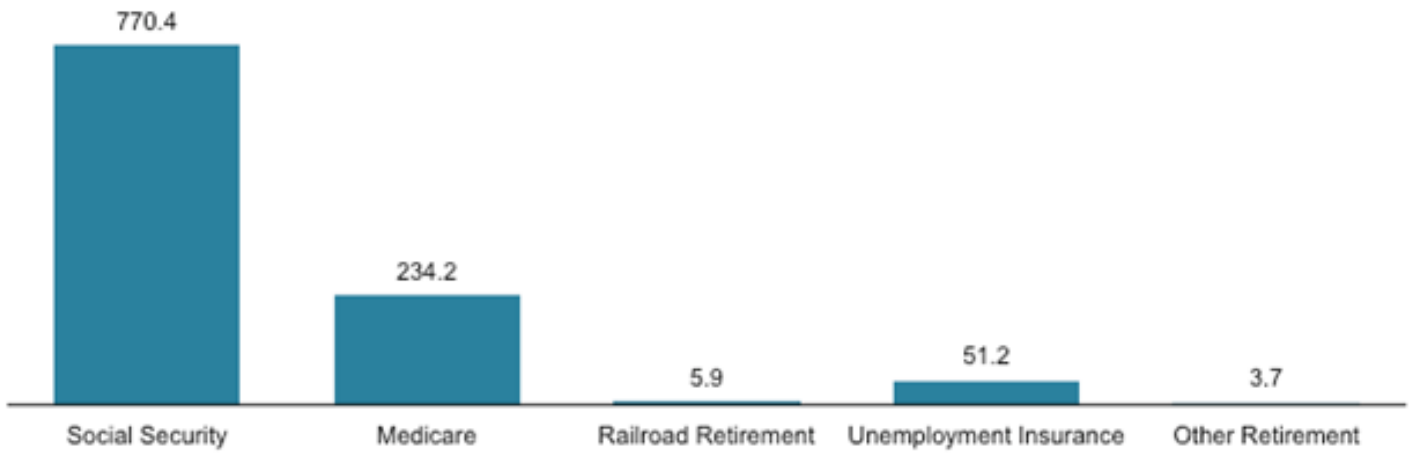
Q. What are the major federal payroll taxes, and how much money do they raise?

A. Payroll taxes are levied to finance Social Security, the hospital insurance portion (Part A) of Medicare, and the federal unemployment insurance program. Revenue totaled just over $1 trillion, or about 6 percent of GDP, in fiscal year (FY) 2015 (figure 1).

FIGURE 1

Federal Social Insurance (Payroll Tax) Contributions by Source

Billions of dollars, FY 2015



Source: OMB Historical Table 2.4.

Key Elements of the U.S. Tax System

What are the major federal payroll taxes, and how much money do they raise?

TABLE 1

Major Federal Payroll Tax Rates and Bases
2017

Source	Wage base	Employer rate	Employee rate	Total rate
Old Age and Survivors Insurance (OASI)	127,200	5.3	5.3	10.6
Disability Insurance (DI)	127,200	0.9	0.9	1.8
Hospital Insurance (HI)	No limit	1.45	1.45	2.9
Federal Unemployment Insurance (UI)	7,000	0.6	-	0.6

Source: Social Security Administration 2017 program fact sheet and Office of Unemployment Insurance program information.
Note: Wage bases for OASI and DI are adjusted each year to account for wage growth. The Bipartisan Budget Act of 2015 reallocated a portion of the OASI tax to DI in 2016-2018. The rates in those years are OASI: 5.015 (employer and employee), DI: 1.185 (employer and employee).

SOCIAL SECURITY

Social Security, or more formally, Old-Age, Survivors, and Disability Insurance (OASDI), provides benefits to elderly and disabled workers, their spouses, and surviving spouses or dependents. It is one of the largest items in the federal budget, with outlays of $897 billion in 2015.

Benefits are mainly financed by a payroll tax on cash wages up to an annual threshold indexed to average wage growth (table 1). In 2017, the maximum taxable wage was $127,200. Employers and employees each contribute 6.2 percent of the workers' wages for a combined 12.4 percent—usually 10.6 percent for the OASI trust fund (retirement and survivors) and 1.8 percent for the DI trust fund (disability). The Bipartisan Budget Act of 2015 temporarily reallocated a portion of the OASI tax to the DI trust fund for 2016-2018 to shore up the DI trust fund, which faced insolvency. For those years, the combined employer and employee rates are 10.03 percent for OASI and 2.37 percent for DI. Most economists believe that the employer portion of the tax, just like the employee portion, is borne by employees in the form of lower compensation.

Over time, Social Security taxes have become a major share of federal revenues. When first collected in 1937, the combined payroll tax rate was 2.0 percent; it raised $765 million (about $12.6 billion in 2015 dollars). In 2015, OASDI taxes totaled over $770 billion and represented 23.7 percent of federal receipts.

HOSPITAL INSURANCE

The hospital insurance (HI) program, or Part A of Medicare, covers inpatient hospital visits and other health care services for the elderly and some others suffering from specified maladies. Federal costs for other parts of Medicare, such as Part B, which covers doctors' and other providers' fees, are not covered by payroll taxes but mainly by general revenues.

The HI program is financed mainly through payroll taxes on workers. Employers and employees each contribute 1.45 percent of the worker's wages toward the HI trust fund for a combined rate of 2.9 percent (table 1). The cap on wages subject to the HI tax was removed in 1994. Also, beginning in 2013, single households

earning more than $200,000 and married households earning more than $250,000 contributed an additional 0.9 percent of earnings over those thresholds (there is no employer portion for this "surtax").

In 1966, the first year of HI tax collections, the combined tax rate was 0.7 percent, and collections totaled $1.9 billion (about $13.9 billion in 2015 dollars). In 2015, HI taxes surpassed $234 billion.

UNEMPLOYMENT INSURANCE

Unemployment insurance (UI) provides insured workers with benefits if they are involuntarily unemployed and meet eligibility requirements. Unemployment insurance programs are run by the states in partnership with the federal government. To finance benefits and program expenses, payroll taxes levied by both the states and the federal government are paid into a federal trust fund.

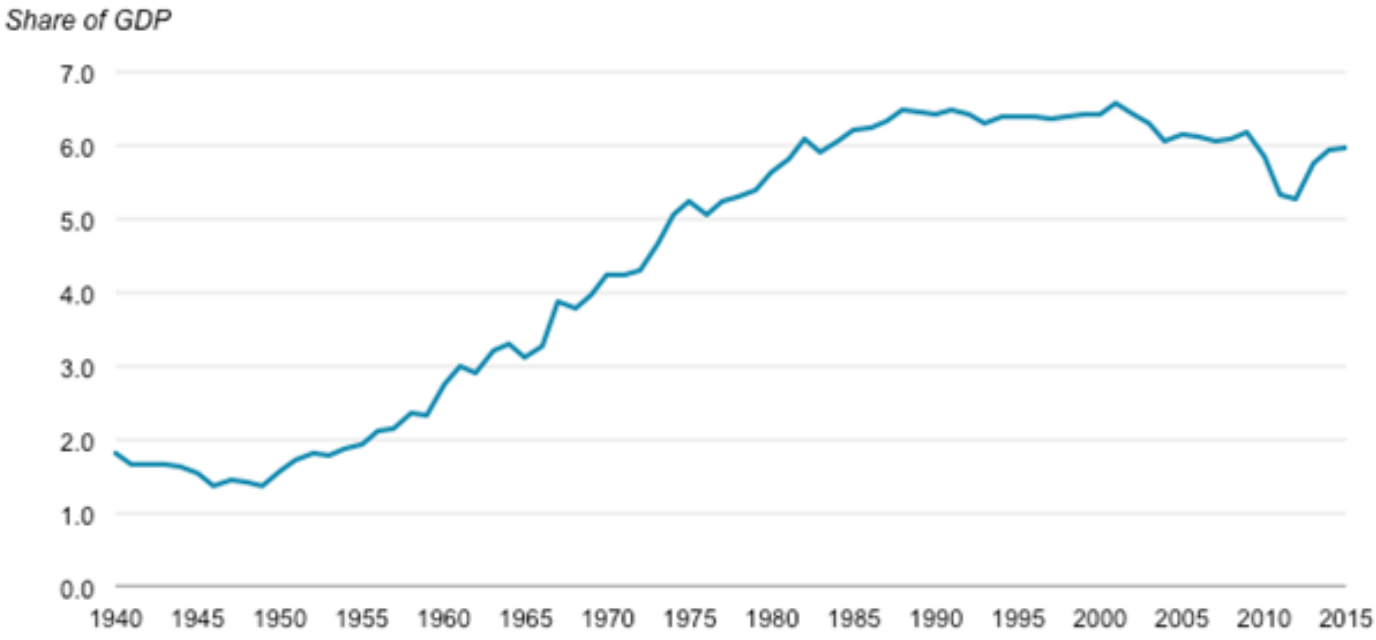
The federal payroll tax rate is 6.0 percent on the first $7,000 of covered wages, but tax credits reduce the effective federal tax rate to 0.6 percent. State unemployment tax rates and wage bases vary, but are usually below 4 percent and are on relatively low wage bases.

In 2015, federal UI taxes totaled about $51 billion.

FIGURE 2

Federal Payroll Tax Receipts as a Percentage of GDP

1940-2015



Source: Calculations from OMB Historical Tables 2.4 and 10.1.

Key Elements of the U.S. Tax System

What are the major federal payroll taxes, and how much money do they raise?

OTHER RETIREMENT PROGRAMS

A handful of other retirement programs are funded by payroll taxes. The largest of these is a retirement program for the railroad industry operated by the Social Security Administration, which functions similarly to Social Security. Retirement programs for federal employees absorb most of the rest of payroll tax receipts.

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Q. What is the unemployment insurance trust fund, and how is it financed?

A. Unemployment insurance assists workers who become involuntarily unemployed and meet specified eligibility requirements. Unemployment insurance programs are run as federal-state partnerships financed through payroll taxes.

The federal unemployment insurance (UI) trust fund finances the costs of administering unemployment insurance programs, loans made to state unemployment insurance funds, and half of extended benefits during periods of high unemployment. Unemployment insurance programs pay benefits to covered workers who become involuntarily unemployed and meet specified eligibility requirements, such as actively looking for work.

Unemployment insurance is structured as a partnership between the federal government and states and territories. States and territories set the parameters of their unemployment programs within federal guidelines, including payroll tax rates and wage bases for covered workers. State unemployment insurance taxes are paid by employers and remitted to the federal UI trust fund, where each state has a separate account for covering normal unemployment insurance benefits.

IIn addition, a 6 percent federal payroll tax, known as the Federal Unemployment Insurance Tax Act (FUTA) tax, is levied on the first $7,000 of covered workers' earnings. Employers remit the tax, but can claim credits against 5.4 percentage points of FUTA taxes paid in states with unemployment programs that meet federal standards (currently all states), reducing the effective tax rate to 0.6 percent, or a maximum of $42 per worker. The federal fund is used to cover administrative expenses, make loans to states if they deplete their own reserves, and cover half of extended unemployment benefits made available when states experience prolonged periods of high unemployment. States cover the other half of these extended benefits.

States can borrow from the federal fund if their own reserves are insufficient. The Great Recession hit state UI reserves particularly hard and 36 states borrowed from the federal fund. By December 2016, all states but California and the US Virgin Islands had repaid their outstanding balances. Loans from the federal fund can be repaid by reducing the credit that employers can claim against FUTA taxes and through other add-ons.

What is the unemployment insurance trust fund, and how is it financed?

Further Reading

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Q. What are the Social Security trust funds, and how are they financed?

A. They provide cash benefits to the elderly and disabled as well as their spouses and dependents, and they are funded chiefly through payroll taxes.

There are two Social Security trust funds: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI), though the two are often analyzed together as Old-Age, Survivors, and Disability Insurance (OASDI). The funds finance benefits for eligible retired and disabled workers and their spouses, dependents, and survivors. When revenue dedicated to financing the programs exceeds program expenses, the surplus is credited to their respective trust funds, which invest in special interest-bearing Treasury bonds. When program costs exceed receipts, the Social Security Administration can redeem its bonds to cover expenses, until it runs out of bonds. The US Treasury pays its obligation to the trust funds from general government funds (table 1).

TABLE 1

Social Security Trust Fund Receipts and End of Year Assets

Billions of dollars, 2015

Source	OASI	DI	Total
Net payroll tax contributions	679.5	115.4	794.9
Income from taxation of benefits	30.6	1.1	31.7
Reimbursements from the general fund of the Treasury	0.3	-	0.3
Net interest	91.2	2.1	93.3
Total income	801.6	118.6	920.2
Assets at end of the year	2,780.3	32.3	2,812.6

Source: Social Security Annual Trustees Report, 2016.

Key Elements of the U.S. Tax System

PAYROLL TAXES: FICA AND SECA

The Social Security trust funds are financed chiefly through payroll taxes on workers covered by the OASDI program. Employers and employees each contribute 5.3 percent of the employee's taxable wages for OASI and 0.9 percent of the employee's taxable wages for DI coverage as part of what are sometimes called Federal Insurance Contribution Act (FICA) taxes. Up to $127,200 in wages is subject to FICA taxes, a threshold that is updated for average wage growth each year. (A portion of FICA taxes dedicated to the separate Medicare hospital insurance trust fund is not subject to this wage cap.) Because the employer portion represents the cost of hiring workers, economists believe that this tax is passed on to workers in the form of lower compensation. Thus workers effectively bear the entire tax.

Self-employed workers covered by Social Security contribute both the employer and employee portions of the tax under the Self-Employment Contribution Act (SECA) but are allowed to deduct the employer portion from their federal taxable income, just as other employers and employees can deduct or exclude employer FICA contributions from their taxable income.

OTHER FINANCING SOURCES

Social Security benefits are partially taxable for beneficiaries whose incomes exceed a threshold. The revenues are remitted to the OASI, DI, and hospital insurance (HI) trust funds. The trust fund balances also earn interest from the special interest-bearing Treasury bonds. Congress sometimes adds to the trust funds directly from general funds. For example, when the payroll tax was cut temporarily as a stimulus measure in 2011 and 2012, the trust funds were reimbursed for the lost revenue.

TRUST FUND SOLVENCY AND GOVVERNMENT-WIDE DEFICITS

Both the OASI and DI trust funds face shortfalls as benefits currently exceed taxes paid in each; in the near future, benefits from the combined OASDI trust fund will exceed revenues, including interest payments from the Treasury. Considered separately, Social Security's actuaries projected in the 2016 Trustees' Report that the DI trust fund will be exhausted by 2023 and the OASI trust fund will be exhausted by 2035. If either event occurs, the Social Security Administration will only be able to pay a portion of benefits from payroll taxes collected, about three-quarters of promised benefits in the case of Social Security.

When the DI fund came close to depletion in 1994, Congress diverted some of the OASI fund's payroll tax receipts to the DI fund to maintain its solvency. Legislators took this step again in 2015, transferring funds from the OASI trust fund to the DI trust fund to keep the DI fund solvent through 2023.

To restore long-term trust fund solvency, policymakers will have to make changes to the program through some combination of raising the payroll tax rate, reducing benefits, and tapping other sources of revenue. To avoid the effect of the ever-growing deficit of benefits relative to taxes already occurring, which add to the unified government deficits, policymakers need to act soon. The sooner policymakers make adjustments, the less dramatic those adjustments will need to be.

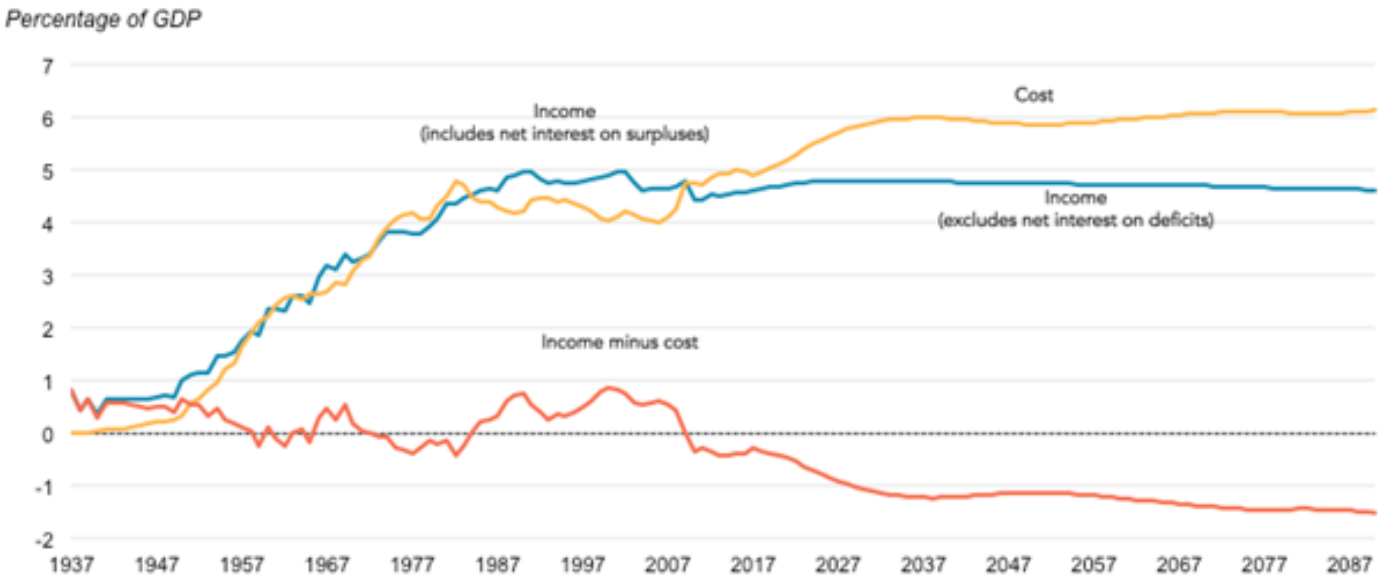
Key Elements of the U.S. Tax System

What are the Social Security trust funds, and how are they financed?

FIGURE 1

OASDI Cost and Income as a Percentage of GDP

1937-2090



Source: Calculations from data from 2016 OASDI Trustees' Report, *Annual Supplement to the Social Security Bulletin*, and BEA.

Data Sources

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Q. Are the Social Security trust funds real?

A. Social Security trust funds are real and hold real Treasury securities for which the federal government has an obligation to pay. They reflect any accumulated excess of Social Security taxes plus other revenues, such as interest received, over expenditures. At the same time, the trust funds "fund" only a tiny portion of outstanding obligations. The trust funds are invested in special-issue Treasury securities backed by the full faith and credit of the federal government.

Social Security was designed primarily as a "pay-as-you-go" system. Instead of prefunded accounts for individuals, benefits are paid mainly out of contributions from current workers. For the most part, money going into the system immediately goes out to pay for benefits.

When Social Security's receipts from payroll taxes and other sources exceed program costs, as it has while the large baby boom generation dominated the workforce, excess funds have been used to purchase special-issue U.S. Treasury bonds that bear interest. In effect, the Social Security trust fund lends the money to the general fund.

Where does the money go? When the non–Social Security part of government is running deficits, the money funds all other government activities. When the trust funds themselves run deficits, they add to these other non–Social Security deficits to produce an even larger unified fund deficit. Because these special-issue bonds are essentially both sold and held by the government, aren't publicly traded like other financial assets, and represent IOUs from the government, some people believe that the trust funds are nothing more than an accounting fiction.

Another factor further confuses the issue. Because the trust funds represent an asset to one side of government (the Social Security Administration) and a liability to another side of government (the general fund), some accounting presentations make the overall effect of the trust funds on the budget look "neutral," when in fact there are future obligations to be paid.

So are the trust funds real? Yes. They have legal consequences for the Treasury and are backed by the full faith and credit of the federal government, just like any other Treasury bond. If and when the Social Security Administration redeems the bonds, the government has a legal obligation to pay the money back with interest, with no additional appropriation by Congress required.

Are the Social Security trust funds real?

To be clear, the trust funds are not a free lunch for taxpayers. Money from the general fund used to repay debts to the trust funds cannot be used for other purposes, like building roads or providing for national defense. And as an additional outlay for the government, those general fund payments increase the Treasury's need to borrow from the public, increasing federal deficits and adding burdens on future taxpayers.

For all the heat about whether the trust funds exist, the debate misses a larger issue: the long-term fiscal challenges posed by Social Security and Medicare are not due to inadequate trust funds, which will be depleted after only a few years of draw-down, but to decades-long imbalances between promised benefits and the revenues required to fund those benefits.

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Q. What is the Medicare trust fund, and how is it financed?

A. The Medicare trust fund finances health services for beneficiaries of Medicare, a government insurance program for the elderly, the disabled, and people with qualifying health conditions specified by Congress. It is financed by payroll taxes, general tax revenue, and premiums paid by enrollees.

The Medicare trust fund comprises two separate funds. The hospital insurance trust fund is financed mainly through payroll taxes on earnings and income taxes on Social Security benefits. The Supplemental Medical Insurance trust fund is financed by general tax revenue and premiums paid by enrollees.

HOSPITAL INSURANCE TRUSTFUND

The hospital insurance (HI) trust fund, also known as Part A of Medicare, finances health care services related to stays in hospitals, skilled nursing facilities, and hospices for eligible beneficiaries, who are mainly people over age 65 with a sufficient history of contributions to the program.

The HI trust fund had receipts of $275 billion and a balance of $205 billion in 2015 (table 1). The fund's chief revenue sources are payroll taxes and income from the taxation of Social Security benefits. Interest payments on trust fund balances, premiums from voluntary enrollees who are not eligible for Medicare coverage based on their earnings records, transfers from the general fund and the Railroad Retirement account, and miscellaneous receipts supply the remainder of revenues.

SUPPLEMENTAL MEDICAL INSURANCE TRUST FUND

The Supplemental Medical Insurance (SMI) trust fund finances two voluntary Medicare programs: Part B, which mainly covers physician services and medical supplies, and Part D, the newer prescription drug program.

The SMI trust fund received $369 billion in revenues and had $69.5 billion in assets in 2015 (table 2). Unlike the HI fund, there are no dedicated payroll taxes for SMI. Instead, the fund's chief revenue sources are contributions from the general fund (receipts from other sources, such as individual income taxes, corporate taxes, and excise taxes), premiums from participants (there are separate premiums for Parts B and D), and a small amount of interest on trust fund balances and miscellaneous receipts. Because the bulk of SMI's funding comes from the general fund, the trust fund balance mainly serves to cover temporary shortfalls, and is kept relatively low. High reserves are not required as long as general fund revenues and borrowing automatically rise with costs.

TABLE 1

Hospital Insurance Trust Fund Receipts and End of Year Assets

Millions of dollars, 2015

Sources	Receipts and assets
Payroll taxes	241,075
Income from taxation of benefits	20,208
Transfers from Railroad Retirement accou	595
General fund reimbursements	187
Premiums from voluntary enrollees	3,206
Interest on investments and other income	10,081
Total income	275,352
Assets at end of the year	205,366

Source: 2016 Medicare Trustees Report expanded and supplemental tables, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/TrusteesReports.html

SOLVENCY AND BUDGET PRESSURES

Like the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds, the HI trust fund faces long-term deficits (figure 1). (The SMI fund, primarily financed by the general revenue, does not face these trust fund imbalances, though it still adds growing pressure to the overall budget.) As the number of Medicare beneficiaries increases from about 55 million in 2015 to 81 million by 2030, the number of workers per beneficiary will decline from 3.1 to 2.4. The cost of health care has increased rapidly as well—though this dynamic has slowed but not stopped in recent years, during and following the Great Recession—putting further pressure on program costs. The HI trust expenditures exceeded taxes for several years up to 2014, and though its outflows and inflows have roughly stabilized for a few years, it is projected to be exhausted by 2028. These pressures now and in the future will force lawmakers to find ways to finance promised benefits or make cuts in services or provider payment rates.

TABLE 2

Supplementary Medical Insurance Trust Fund Receipts and End of Year Assets

Millions of dollars, 2015

Sources	Receipts and assets
Premiums from enrollees	82,204
General fund transfers	272,245
Transfers from states	8,900
Interest and other income	5,738
Total income	369,087
Assets at end of the year	69,470

Source: 2016 Medicare Trustees Report expanded and supplemental tables, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/TrusteesReports.html

Key Elements of the U.S. Tax System

What are the major federal excise taxes, and how much money do they raise?

Q. What are the major federal excise taxes, and how much money do they raise?

A. Federal excise tax revenues—mostly collected from sales of motor fuel, airline tickets, tobacco, alcohol, and health-related goods and services—totaled $98.3 billion in fiscal year 2015, or 3 percent of federal tax receipts.

Excise taxes are narrowly based taxes on consumption, levied on specific goods, services, and activities. They can be either a per-unit tax (such as the per-gallon tax on gasoline) or a percentage of price (such as the airline ticket tax). Generally, excise taxes are collected from producers or wholesalers, and are embedded in the price paid by final consumers.

Federal excise tax revenue has declined over time relative to the size of the economy. As a percentage of gross domestic product (GDP), excise tax revenue fell from 2.7 percent in 1950 to 0.7 percent by 1979 (figure 1). Receipts temporarily increased as a result of the crude oil windfall profit tax imposed in 1980, but excluding that tax, revenue held fairly steady (the dashed line in figure 1) at about 0.7 percent of GDP through the 1980s and 1990s. Excise tax revenues as a percent of GDP gradually declined again throughout the 2000s to roughly 0.5 percent in recent years.

This revenue is either transferred to the general fund or allocated to trust funds dedicated to specified purposes. General fund excise taxes account for roughly 40 percent of total excise receipts, with the remaining 60 percent going to trust funds.

General fund excise taxes are imposed on many goods and services, the most prominent of which are alcohol, tobacco, and health insurance. Other general fund excise taxes include taxes on local telephone service, vehicles with low-mileage ratings ("gas guzzlers"), ozone-depleting chemicals, indoor tanning services, and medical devices.

Excise taxes dedicated to trust funds finance transportation and well as environmental- and health-related spending. The Highway Trust Fund and the Airport and Airway Trust Fund account for over 90 percent of trust fund excise tax receipts, mostly from taxes on gasoline and other transportation fuels (Highway Trust Fund), and air travel (Airport and Airway Trust Fund). Five categories of excise taxes—highway, tobacco, air travel, health, and alcohol—accounted for 94 percent of total excise tax receipts in fiscal year (FY) 2015 (figure 2).

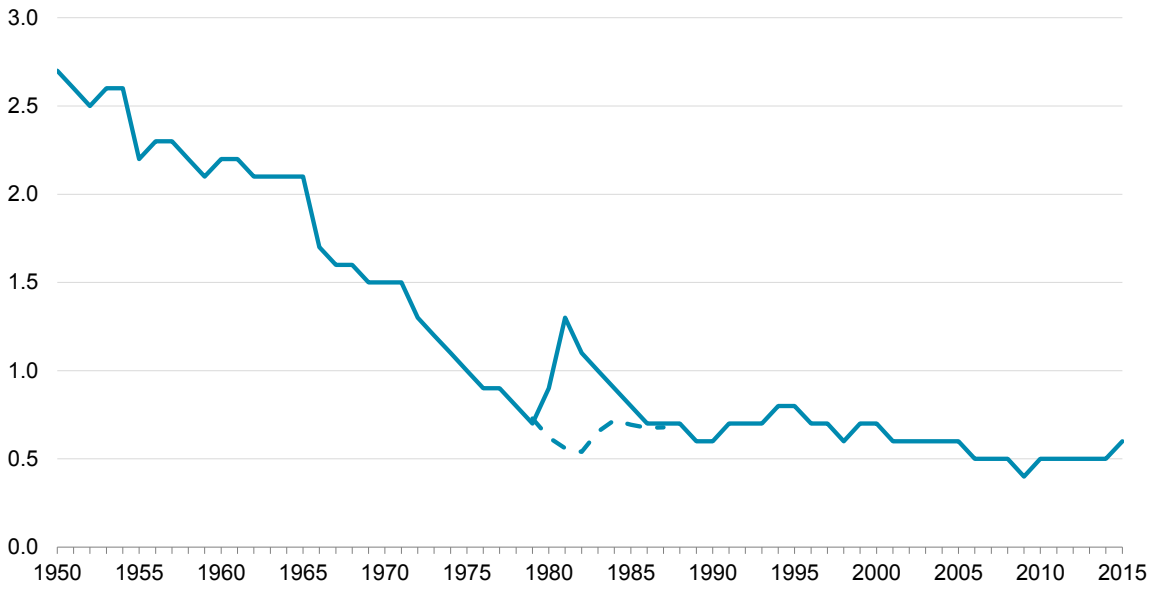
Key Elements of the U.S. Tax System

What are the major federal excise taxes, and how much money do they raise?

FIGURE 1

Federal Excise Tax Revenue as a Share of GDP

1950-2015



Source: Office of Management and Budget, Historical Tables 2.3 and 2.4.
Note: The dashed line excludes receipts from the Crude Oil Windfall Profit Act of 1980.

EXCISE TAXES DEDICATED TO THE HIGHWAY TRUST FUND

Highway-related excise tax revenue totaled $37.4 billion in FY2015, 38.1 percent of all excise tax revenue. Gasoline and diesel taxes, which are 18.4 and 24.4 cents per gallon, respectively, make up over 90 percent of total highway tax revenue, with the remaining from taxes on other fuels, trucks, trailers, and tires. (The tax rates for gasoline and diesel include a 0.1 percent tax that is earmarked for the Leaking Underground Storage Tank Trust Fund.) Most other motor fuels are also subject to excise taxes, although "partially exempt" fuels produced from natural gas are taxed at much lower rates. Tax credits for producers of certain fuels deemed environmentally superior—including biodiesel, renewable diesel mixtures, alternative fuel, and alternative fuel mixtures —expired at the end of 2014 but were extended retroactively to January 1, 2015, and through 2016.

TOBACCO EXCISE TAXES

Revenue from tobacco taxes totaled $14.5 billion in FY2015, accounting for 14.7 percent of all excise tax revenue. Federal excise taxes are imposed on tobacco products, which include cigarettes, cigars, snuff, chewing tobacco, pipe tobacco, and roll-your-own. The tax is calculated per thousand cigars or cigarettes, or per pound of tobacco, depending on the product. The tax equals about $1.00 per pack of 20 cigarettes. Cigarette papers and tubes are also subject to tax. Tobacco taxes are collected when the products leave bonded premises for domestic distribution. Exported products are exempt. Unlike other excise taxes that are collected by the IRS, alcohol and tobacco taxes are collected by the Alcohol and Tobacco Tax and Trade Bureau of the US Treasury Department.

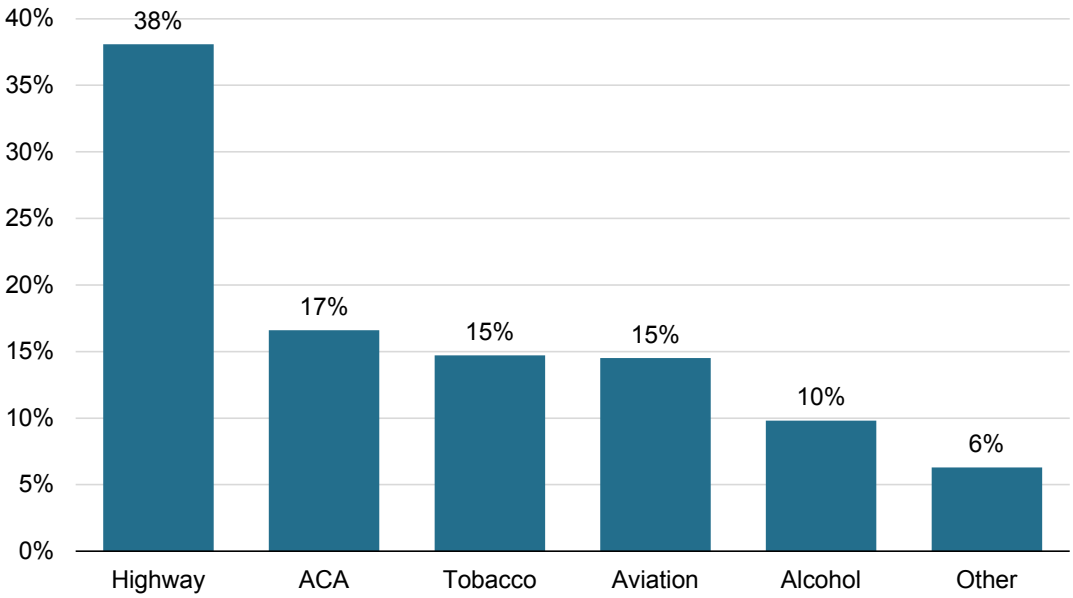
Key Elements of the U.S. Tax System

What are the major federal excise taxes, and how much money do they raise?

FIGURE 2

Composition of Total Federal Excise Tax Revenue

FY2015



Source: Office of Management and Budget, Historical Table 2.4.

EXCISE TAXES DEDICATED TO THE AIRPORT AND AIRWAY TRUST FUND

Revenue from excise taxes dedicated to the Airport and Airway Trust Fund totaled $14.3 billion in FY2015, accounting for 14.5 percent of all excise tax receipts. According to Congressional Budget Office data, more than 90 percent of aviation excise taxes came from taxing passenger air fares, with the remaining coming from taxes on air cargo and aviation fuels.

Domestic air travel is subject to a 7.5 percent tax based on the ticket price plus $4.00 (in 2016) for each flight segment (one takeoff and one landing). A 6.25 percent tax is charged on domestic cargo transportation. International arrivals and departures are taxed at $17.80 per person (in 2016); there is no tax on international cargo. Both the domestic segment fee and the international arrivals and departures fee are indexed for inflation.

Key Elements of the U.S. Tax System

What are the major federal excise taxes, and how much money do they raise?

HEALTH CARE RELATED EXCISE TAXES ENACTED BY THE AFFORDABLE CARE ACT

The Affordable Care Act (ACA) legislation passed in 2010 contained several health-related excise taxes. Currently, the largest is an annual fee on health insurance providers. This fee represents a fixed aggregate amount for each calendar year ($11.3 billion for 2015), which is imposed on insurance providers according to their market share. Starting in 2014, an annual fee also applies to manufacturers and importers of branded prescription drugs ($3 billion per year in 2014 through 2016). A 40 percent excise tax on certain high-cost employer sponsored health insurance plans (the "Cadillac tax") was scheduled to begin in 2018 but Congress passed a two-year postponement of the excise tax, which will now begin in 2020. Other health care–related excise taxes include a 2.3 percent tax on medical devices and a 10 percent tax on indoor tanning services. Congress suspended the excise tax on medical devices for two years for medical device sales in 2016 and 2017. In addition, the ACA imposes excise taxes on individuals without essential health insurance coverage (the "individual mandate") as an incentive to buy it, and on large employers that choose not to offer health care coverage (the "employer mandate").

ACA-related excise tax revenue totaled $16.3 billion in FY2015, 16.6 percent of total excise receipts. Revenue from these excise taxes is scheduled to increase significantly over the 10-year budget window and will account for about 22 percent of all federal excise tax revenue from 2017 through 2026.

ALCOHOL EXCISE TAXES

Excise tax revenue from alcoholic beverages amounted to $9.6 billion in FY2015, 9.8 percent of total excise receipts. There are different tax rates for distilled spirits, wine, and beer. Distilled spirits are taxed at $13.50 per proof gallon (a proof gallon is one liquid gallon that is 50 percent alcohol); tax rates on wines vary based on type and alcohol content, ranging from 22.6 cents per gallon for hard cider to $3.40 per gallon for sparkling wines; beer is typically taxed at $18.00 per barrel (31 gallons), although a reduced rate of $7.00 per barrel applies to the first 60,000 barrels for breweries that produce less than two million barrels. Note that the alcohol content of beer and wine is taxed at a much lower rate than the alcohol content of distilled spirits. Alcohol products can be exported or delivered for nonbeverage uses without incurring the tax.

Data Sources

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What is the highway trust fund, and how is it financed?

Q. What is the Highway Trust Fund, and how is it financed?

A. The Highway Trust Fund finances most federal government spending for highways and mass transit. Revenues for the trust fund come from transportation-related excise taxes, primarily federal taxes on gasoline and diesel fuel. In recent years, however, the trust fund has needed significant transfers of general revenues to remain solvent.

The federal Highway Trust Fund tracks federal spending and revenue for surface transportation. The trust fund has separate accounts for highways and mass transit. Because obligations from the trust fund generally are for capital projects that take several years to complete, outlays reflect projects authorized by Congress in previous years.

Most spending from the Highway Trust Fund for highway and mass transit programs is through federal grants to state and local governments. The federal government accounts for about one-quarter of all public spending on roads and highways, with the remaining three-quarters financed by state and local governments.

Financing the Trust Fund

The Congressional Budget Office estimates that Highway Trust Fund tax revenue will total $40.9 billion in fiscal year 2017 (Congressional Budget Office 2017). Revenue from the federal excise tax on gasoline ($25.7 billion) and on diesel fuel ($9.6 billion) accounts for 86 percent of the total. The remaining trust fund tax revenue comes from a sales tax on tractors and heavy trucks, an excise tax on tires for heavy vehicles, and an annual use tax on those vehicles. In addition to dedicated tax revenue, the trust fund receives a small amount of interest on trust fund reserves.

The current tax rate is 18.4 cents per gallon for gasoline and ethanol-blended fuels and 24.4 cents per gallon for diesel (0.1 cent of each tax is dedicated to the Leaking Underground Storage Tank Trust Fund). The tax rates on motor fuels have not changed since 1993 and thus have failed to keep pace with price increases for gasoline and diesel fuel. If tax rates had been indexed for inflation since 1993, the current tax on gasoline would be about 31 cents per gallon and the tax on diesel fuel would be about 42 cents per gallon. Although the current taxes on motor fuels (except for a residual tax of 4.3 cents per gallon) are set to expire at the end of September 2020, Congress has routinely extended the taxes in the past.

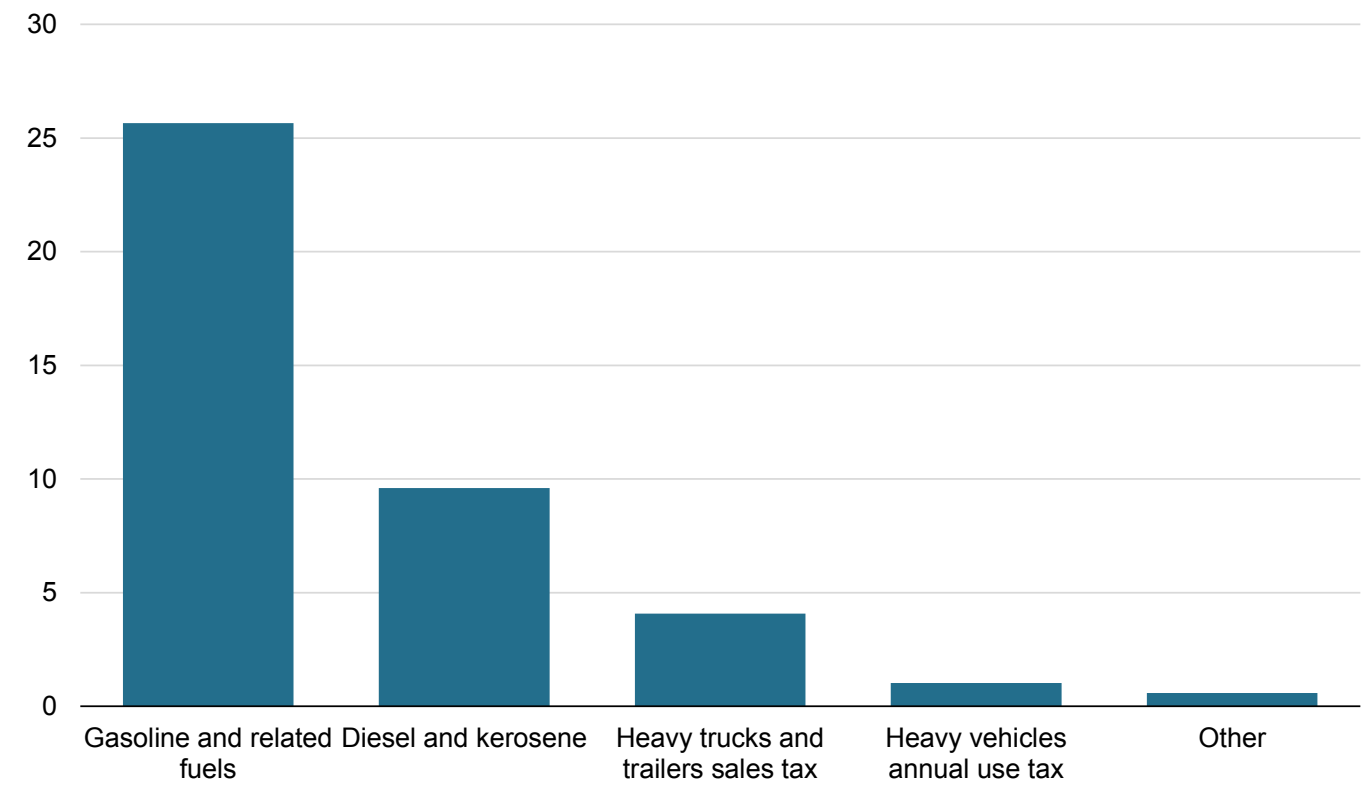
Key Elements of the U.S. Tax System

What is the highway trust fund, and how is it financed?

FIGURE 1

Highway Trust Fund Revenue by Source, 2017

Billions of dollars



Source: Congressional Budget Office. 2017. *An Update to the Budget and Economic Outlook: 2017 to 2027*. Washington, DC: Congressional Budget Office.

Trust Fund Balances

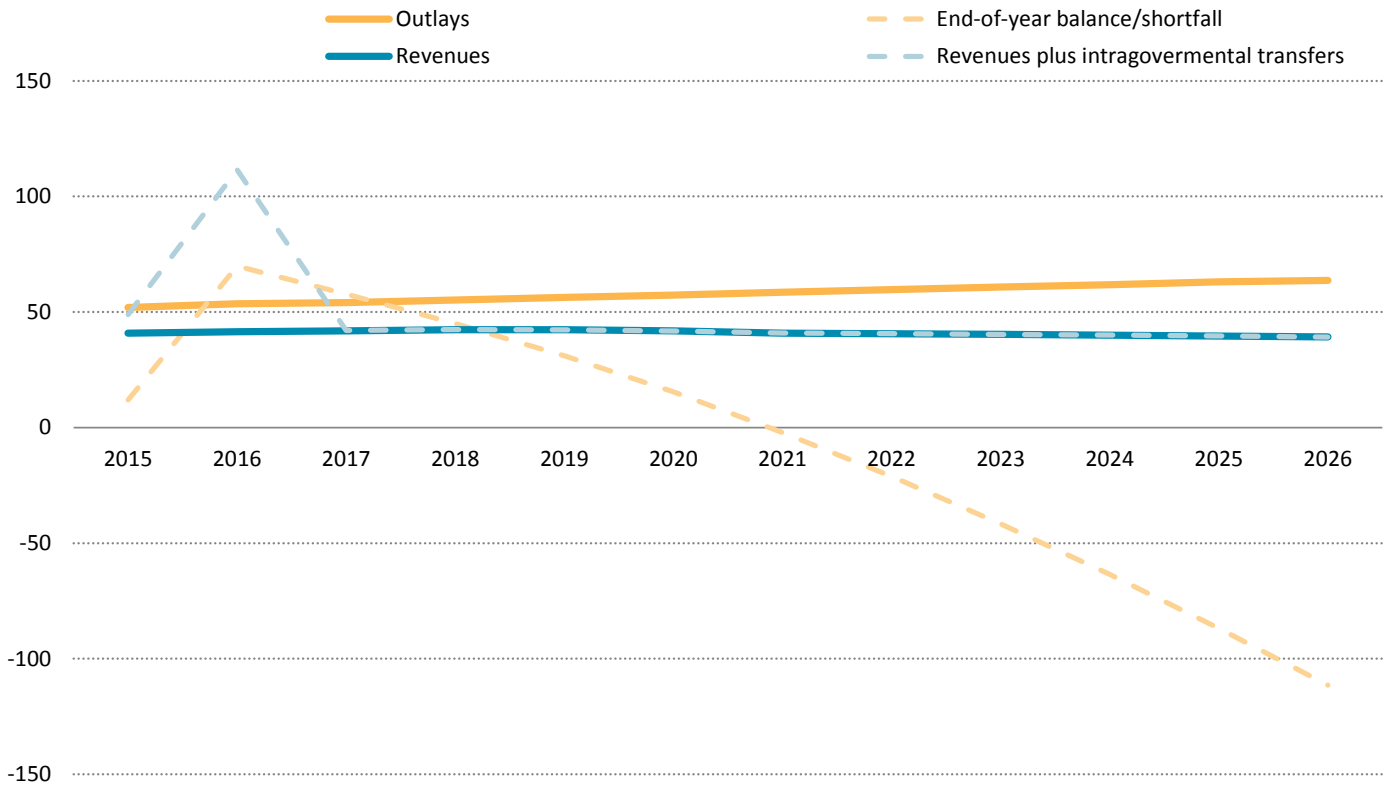
Before 2008, highway tax revenue dedicated to the trust fund was sufficient to pay for outlays from the fund, but that has not been true in recent years. Since 2008, Congress has sustained highway spending by transferring $143 billion of general revenues to the fund, including $70 billion in 2016 as a result of legislation enacted at the end of 2015.

Those transfers will enable the trust fund to meet spending obligations through 2020, but projected shortfalls will appear again starting in 2021. The Congressional Budget Office projects that outlays from the Highway Trust Fund will exceed trust fund reserves by a cumulative $75 billion for the highway account and by $32 billion for the mass transit account from 2016 through 2026, even assuming that expiring trust funds taxes are extended (Congressional Budget Office 2016).

FIGURE 2

Highway Trust Fund Account Projections, 2015-2016

Billions of dollars



Source: Congressional Budget Office. 2016. *An Update to the Budget and Economic Outlook: 2016 to 2026*.
Notes: Revenues include a small amount of interest on trust fund reserves. Under current law, the Highway Trust Fund cannot incur negative balances.

Options for Financing Federal Spending on Highways and Mass Transit

Drivers likely would respond to an increase in motor fuels taxes by driving less, which would reduce pollution and lessen the need for highway construction and maintenance. But drivers may also respond by driving more fuel-efficient vehicles, which would weaken the incentive to reduce miles driven.

Motor fuels taxes link highway use with the associated costs of building and maintaining roads as well other costs associated with fuel consumption, such as pollution and dependence on foreign oil. But motor fuels taxes are an imperfect user fee because they do not differentiate among vehicles that cause greater or lesser road wear for the same amount of fuel consumed or between travel on crowded and uncrowded roads.

A tax on vehicle miles driven would provide a more direct link to the cost of highway use but, unlike an increase in the tax on motor fuels, would be difficult to implement, requiring new tolls or electronic motoring of vehicles. An advantage of a vehicle mileage tax is that it could adjust to reflect the additional costs of congestion by increasing tolls or the tax rate in certain locations and at certain times of the day. A vehicle mileage tax would not, however, provide an incentive for driving more fuel-efficient vehicles.

Alternatively, Congress could abandon the user-pay principle and simply pay for highways through general revenues. Highway spending would no longer have a dedicated source of revenue and would instead compete with other spending programs for general revenue funding through the annual appropriations process. Or Congress could decide to limit federal highway spending to the amount of revenue collected from exiting motor fuels taxes. This would require curtailing some existing highway projects and not starting others, at a time when the nation's infrastructure is already in need of repair.

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Q. What tax incentives encourage energy production from fossil fuels?

A. Provisions of the federal income tax that subsidize domestic production of fossil fuels include the expensing of exploration, development, and intangible drilling costs; the use of percentage depletion instead of cost depletion to recover drilling and development costs of oil and gas wells and coal mining properties; and numerous smaller incentives for production and distribution of oil, coal, and natural gas.

Various tax incentives promote investment in fuel development, presumably diverting capital from investments in other assets with higher pretax yields. Several studies have found that the effective marginal tax rate—the extent to which all applicable tax provisions reduce the after-tax return on new investment—is much lower for oil, gas, and coal development than for other assets. The Obama administration proposed eliminating these incentives in most of their budgets, but Congress took no action.

Supporters justify these tax incentives as a means of reducing US dependence on imported oil. 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 between $11 billion and $26 billion from 2015 to 2019, depending on the agency doing the estimate (figure 1).

Intangible drilling costs cover the labor, machinery, and materials needed for drilling and developing oil and gas wells and coal mines. Independent oil and gas producers (i.e., 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 many years. Integrated oil and gas companies may deduct 70 percent of these costs in the first year and recover the remaining 30 percent over the next five years.

With percentage depletion, producers can deduct a fixed percentage of gross revenue from a property as capital expenses each year; in contrast, with conventional 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 law includes several smaller (but hardly trivial) incentives for investments in refineries, pipelines, oil

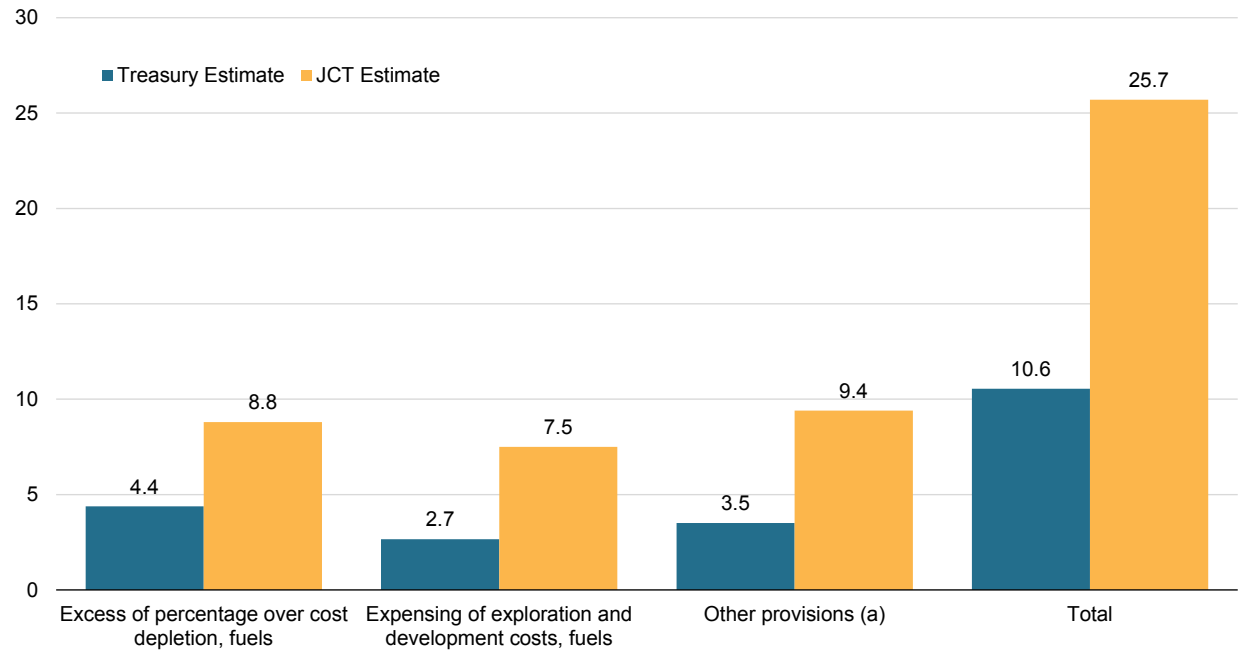
What tax incentives encourage energy production from fossil fuels?

FIGURE 1

Revenue Losses from Largest Tax Incentives for Energy Production from Fossil Fuels

2015-19

Billions of dollars



Sources: Office of Management and Budget, Fiscal Year 2017, Analytical Perspectives Tax Expenditures, Table 14-1, Estimates of Total Income Tax Expenditures for Fiscal Years 2015-2025; Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2015-1019, JCX-141R-15, December 7, 2015.

Note: (a) Includes exemption from passive loss limitations for working interests in oil and gas properties, capital gains treatment of royalties on coal, exclusion of interest on energy facility bonds, credit for investment in clean coal facilities, treatment of natural gas distribution facilities as 15-year property, and amortization of all geological and geophysical expenditures over 2 years.

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. The Obama administration has proposed denying oil and gas companies the benefits of the domestic production deduction, even though the deduction does not favor oil and gas over other domestic manufacturing.

Subsidizing domestic production of fossil fuels is inconsistent with the policy goal of reducing fossil fuel use to counter global climate change. But the adverse effects of the incentives on climate change are minor because any increase in domestic production they induce mostly displaces imports rather than raising domestic fuel consumption.

Some prior research concludes that the incentives reduce the world market price of oil by less than 0.1 percent, which would barely effect consumption of gasoline and other oil-based products. Moreover, a recent study by the National Academy of Sciences finds that subsidies for oil and gas production may slightly reduce greenhouse gas emissions by accelerating the conversion of electricity production facilities from coal to natural gas.

Key Elements of the U.S. Tax System

What tax incentives encourage energy production from fossil fuels?

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Q. What is a carbon tax?

A. Emissions of carbon dioxide and other greenhouse gases are changing the climate. A carbon tax puts a price on those emissions, encouraging people, businesses, and governments to produce less of them. A carbon tax's burden would fall most heavily on energy-intensive industries and lower-income households. Policymakers could use the resulting revenue to offset those impacts, lower individual and corporate taxes, reduce the budget deficit, invest in clean energy and climate adaptation, or for other uses.

WHY TAX CARBON, AND HOW MUCH?

Emissions of carbon dioxide, methane, nitrous oxide, and other greenhouse gases are increasing global temperatures, raising sea levels, shifting rainfall patterns, boosting storm intensity, and harming coral reefs and other marine life. Greenhouse gas emissions thus create a host of potential economic and environmental threats including property damage from storms, human health risks, reduced agricultural productivity, and ecosystem deterioration.(Environmental Protection Agency 2015; National Aeronautics and Space Administration 2015).

Energy prices do not currently reflect these costs of greenhouse gas emissions. Those who benefit from burning fossil fuels generally do not pay for the environmental damage the emissions cause. Instead, this cost is borne by people around the world, including future generations. Imposing a carbon tax can help to correct this externality by raising the price of energy consumption to reflect more of its social cost. The most efficient way to collect such a tax would be upstream from a limited number of fuel producers and importers, rather than downstream from fuel users.

Estimates of the environmental cost of carbon emissions are sensitive to scientific and economic assumptions and thus differ greatly. One prominent estimate, developed by an interagency working group of the United States government, is that carbon dioxide emissions impose social costs of about $40 per metric ton.(US Interagency Working Group on Social Costs of Carbon 2015).

HOW WOULD A CARBON TAX AFFECT WELFARE?

A carbon tax would increase the price of burning fossil fuels and any resulting goods or services. A tax of $40 per ton would add about 36 cents to the price of a gallon of gasoline, for example, or about 2 cents to the average price of a kilowatt-hour of electricity (Marron, Toder, and Austin 2015). Higher energy prices would raise costs for industry and households, resulting in lower profits, wages, and consumption.

The impact of a carbon tax would differ among economic groups depending on the extent of energy price changes and on regional energy production and consumption patterns. Clearly, a carbon tax would fall more heavily on workers and investors in carbon-intensive industries as well as on regions that depend heavily on carbon-intensive fuels, particularly coal.

The distributional impact of a carbon tax would depend on the extent to which businesses could pass on higher energy costs to their customers. If demand for goods is less "elastic" (that is, responds less) to price changes than the supply of goods, then consumers will bear more of the carbon tax burden than investors and workers.

Since low-income households consume a more energy-intensive basket of goods than wealthier households do, a carbon tax would be regressive; it would cost poorer households a higher share of their income than wealthier households (Marron, Toder, and Austin 2015). A carbon tax of $20 per ton would account for about 0.8 percent of pretax income for households in the lowest income quintile, as compared to 0.5 percent in the highest income quintile.

The environmental benefits from reduced emissions would be shared by people around the world. Combatting climate change thus poses a fundamental collective action problem. American reductions will be most valuable if they are accompanied by comparable reductions in other nations.

DEPLOYING THE REVENUE

A carbon tax could raise substantial revenue. The Congressional Budget Office estimated, for example, that a broad-based carbon tax starting at $20 per ton in 2011 and rising to $34.4 per ton over a decade would have raised $1.2 trillion during that period (Congressional Budget Office 2013). This is close to the amount that the US currently raises with all its other excise taxes—about 0.5 percent of GDP per year.

The welfare impact of a carbon tax package would depend on how those revenues are used. Using some revenues to increase transfers, reduce Social Security contributions from low-income households, or compensate workers in carbon-intensive industries could soften the regressive impact of the carbon tax. Revenues from a carbon tax could also be used to finance cuts in taxes that act as a disincentive to growth, such as the corporate income tax (Marron and Toder 2015). However, because tax cuts on profits would largely benefit the wealthy, this would exacerbate the regressivity of the carbon tax. Revenues could also be used to reduce personal income and payroll taxes, to reduce future deficits, or to invest in clean energy and climate adaptation. What combination of those uses to choose depends on political, social, and economic considerations (Marron and Morris 2016).

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Q. How does the corporate income tax work?

A. The United States imposes a tax on the profits of US resident corporations up to a maximum rate of 35 percent. The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes, and raised $343.8 billion in fiscal 2015.

The United States taxes the profits of US resident corporations at graduated rates ranging from 15 to 35 percent. Most corporate income is taxed at the maximum rate.

Taxable corporate profits are equal to a corporation's receipts less allowable deductions—including the cost of goods sold, wages and other employee compensation expenses, interest, nonfederal taxes, depreciation, and advertising. US resident multinationals 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 US parent corporation. To avoid double taxation, US multinationals may claim a credit for taxes paid to foreign governments on income earned abroad, but only up to their US tax liability on that income. US-based corporations owned by foreign multinational companies face the same US corporate tax rules on their profits from US business activities as do US-owned corporations.

The corporate income tax is an entity-level tax that applies to C corporations (named after the relevant subchapter of the Internal Revenue Code). Corporate profits can also be subject to a second layer of taxation at the individual shareholder level, both on dividends when distributed and on capital gains from sale of shares. The maximum tax rate on both dividends and capital gains is currently 23.8 percent (including the 3.8 percent tax on net investment income).

Many US businesses are not subject to the corporate income tax; rather they are taxed as "flow-through" entities. Flow-through businesses do not face an entity-level tax. But their owners must include their allocated share of the businesses' profits in their taxable income under the individual income tax. Flow-through entities include sole proprietorships, partnerships, and eligible corporations that elect to be taxed under subchapter S of the Internal Revenue Code (S corporations).

The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes. It raised $343.8 billion in fiscal 2015, 10.6 percent of all revenue, and 1.9 percent of gross domestic product. 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 revenues equal to about 2 percent of gross domestic product (GDP), with some fluctuations mostly associated with the business cycle (figure 1).

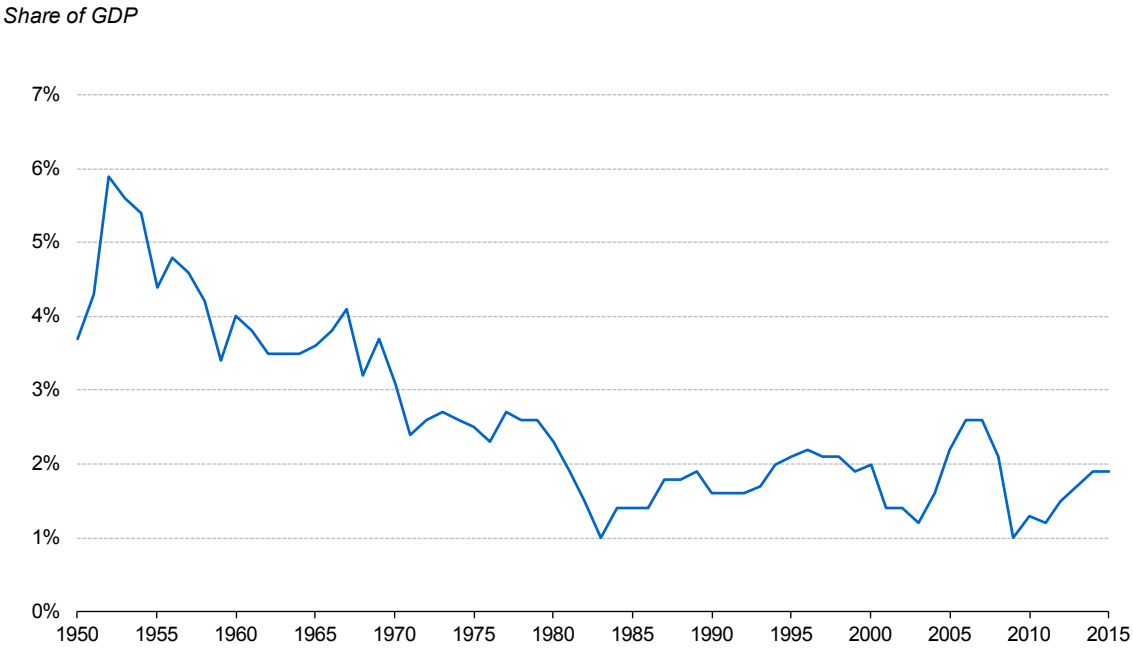
Key Elements of the U.S. Tax System

How does the corporate income tax work?

FIGURE 1

Corporate Income Tax Revenue as a Share of GDP

FY 1950–2015



Source: Office of Management and Budget, Historical Table 2.3.

Data Sources

Office of Management and Budget. Historical table 2.3. *Historical Tables*. "Receipts by Source as Percentage of GDP: 1934–2020."

Q. What are flow-through enterprises and how are they taxed?

A. Most US businesses are not subject to the corporate income tax. Rather, profits flow through to owners and are taxed under the individual income tax. Flow-through businesses include sole proprietorships, partnerships, and S corporations.

Many businesses are taxed as flow-through entities that, unlike C corporations, are not subject to the corporate income tax. Instead their owners include their allocated shares of profits in taxable income under the individual income tax, which is taxed as ordinary income up to the maximum 39.6 percent rate. Flow-through businesses include sole proprietorships, partnerships, and S corporations.

ADVANTAGES OF FLOW-THROUGH ENTITIES

Flow-through businesses generally face the same tax rules as C corporations for inventory accounting, depreciation, and other provisions affecting the measurement of business profits. But organizing as a flow-through business has several advantages. The first is that income is only subject to a single layer of income tax, unlike C corporation profits, which 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 (at rates up to 23.8 percent). In contrast, profits from flow-through businesses are taxed just once, at the owner's individual tax rate for ordinary income.

Another benefit of flow-through status is that individuals may deduct business losses against current income from other sources, subject to some limitations for "passive losses." In contrast, C-corporation losses cannot be used to offset income earned outside the corporation. C-corporation losses may, however, be carried back (up to two years) or carried forward (up to 20 years) and deducted against profits in previous or future years. To the extent corporations are unable to claim loss carrybacks, the tax benefit from these losses is delayed and reduced in terms of present value.

TYPES OF FLOW-THROUGH ENTITIES

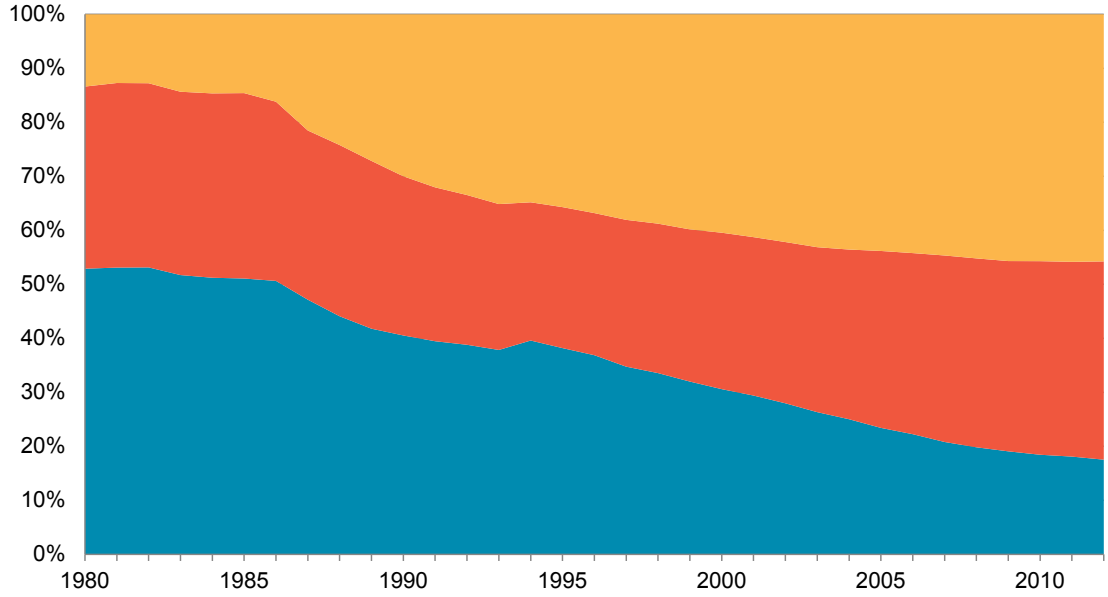
Sole Proprietorships: A business with a single owner does not file a separate tax return, but rather reports its net income on Schedule C of the owner's individual tax return. Generally all net income from sole proprietorships is also subject to payroll taxes under the Self Employed Contributions Act (SECA).
Partnerships: Partnerships file an entity-level tax return (Form 1065), but profits are allocated to owners who

report their share of net income on Schedule E of their individual tax returns. Under "check the box" regulations instituted by the Treasury Department in 1997, limited-liability companies (LLCs) can elect to be taxed as partnerships. General partners are subject to SECA tax on all their net income, while limited partners are only subject to SECA tax on "guaranteed payments" that represent compensation for labor services.
S Corporations: Eligible domestic corporations that elect S-corporation status file a corporate tax return (Form 1120S), but profits flow through to shareholders and are reported on Schedule E of the shareholders personal income tax. S corporations cannot have more than 100 shareholders, and those shareholders must be US citizens or resident individuals (although certain estates, trusts, and tax-exempt organizations are also allowed). In addition, S corporations may have only one class of stock. S corporation owners do not pay SECA tax on their profits, but are required to pay themselves "reasonable compensation," which is subject to the regular Social Security tax (i.e., the Federal Insurance Contributions Act or FICA).

FIGURE 1

Share of Business Returns by Type

1980–2012



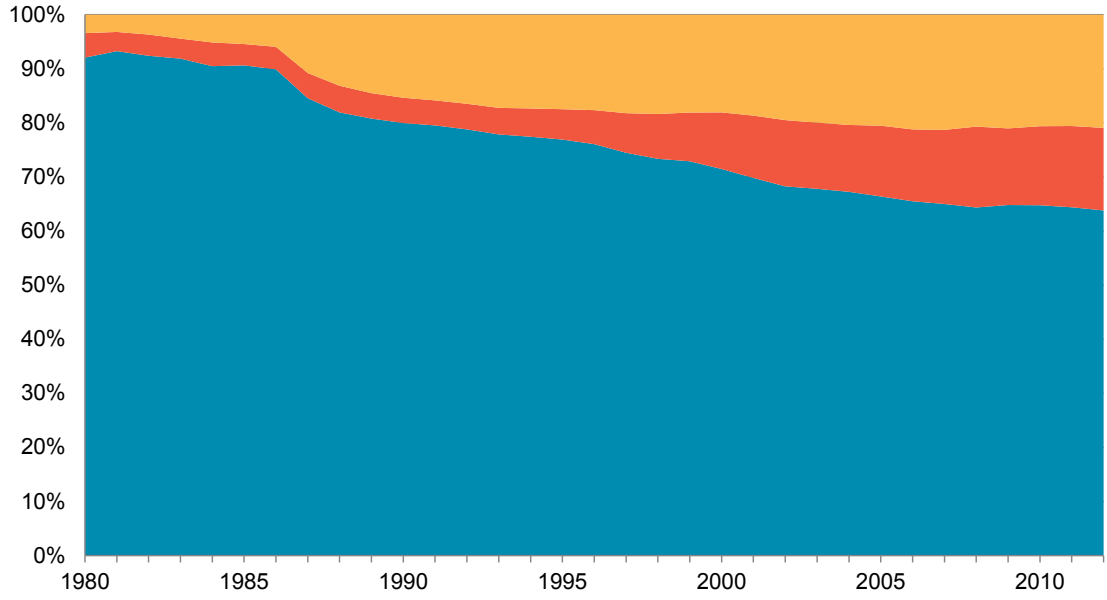
Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.

Key Elements of the U.S. Tax System

What are flow-through enterprises and how are they taxed?

FIGURE 2

Share of Business Receipts by Type
1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.

GROWTH IN FLOW-THROUGH BUSINESSES

The share of business activity represented by flow-through entities has been rising since the passage of the Tax Reform Act of 1986. Excluding sole proprietorships (which receive just 4 percent of total business revenue), more than 80 percent of businesses were organized as flow-through entities in 2012—up from 49 percent in 1985 (figure 1). During that same period the share of business receipts going to flow-through entities increased from 9 percent to 36 percent (figure 2).

Recent research using IRS tax data found that fully half of all business profits are earned by pass-through entities, and that the average federal income tax rate paid is 19 percent (Cooper et al. 2015).

Data Sources

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Plesko, George A., and Eric J. Toder. 2013. "Changes in the Organization of Business Activity and Implications for Tax Reform." *National Tax Journal* 66(4): 855–70.

Q. Is corporate income double-taxed?

A. Yes, as a general rule. A corporation pays tax on its income, and its shareholders pay tax again when the income is distributed. But in practice, not all corporate income is taxed and many corporate shareholders are exempt from income tax.

Since 1909, corporate income has been subject to a federal tax (currently at a top rate of 35 percent). This income is generally taxed a second time when it is distributed as dividends that are liable to the individual income tax.

Suppose a corporation earns $1 million in profits this year and pays $350,000 in federal taxes. If the corporation distributes the remaining $650,000 to its shareholders, the distribution would be taxable to shareholders. Dividends are taxed at a top rate of 23.8 percent. As a result, only $495,300 would be left (assuming the dividends went to high-income individuals), and the combined tax rate on the income would be greater than 50 percent.

Some analysts consider this double-taxation inequitable. It discourages businesses from organizing as C corporations (which are subject to the corporate tax), encouraging them to be S corporations, partnerships, or sole proprietorships. Profits of an S corporation, partnership, or sole proprietorship are taxed only once (at a top rate of 43.4 percent), because the income is automatically passed through to the owners. By no coincidence, in recent years an increasing portion of businesses have been organized as pass-through entities (figure 1).

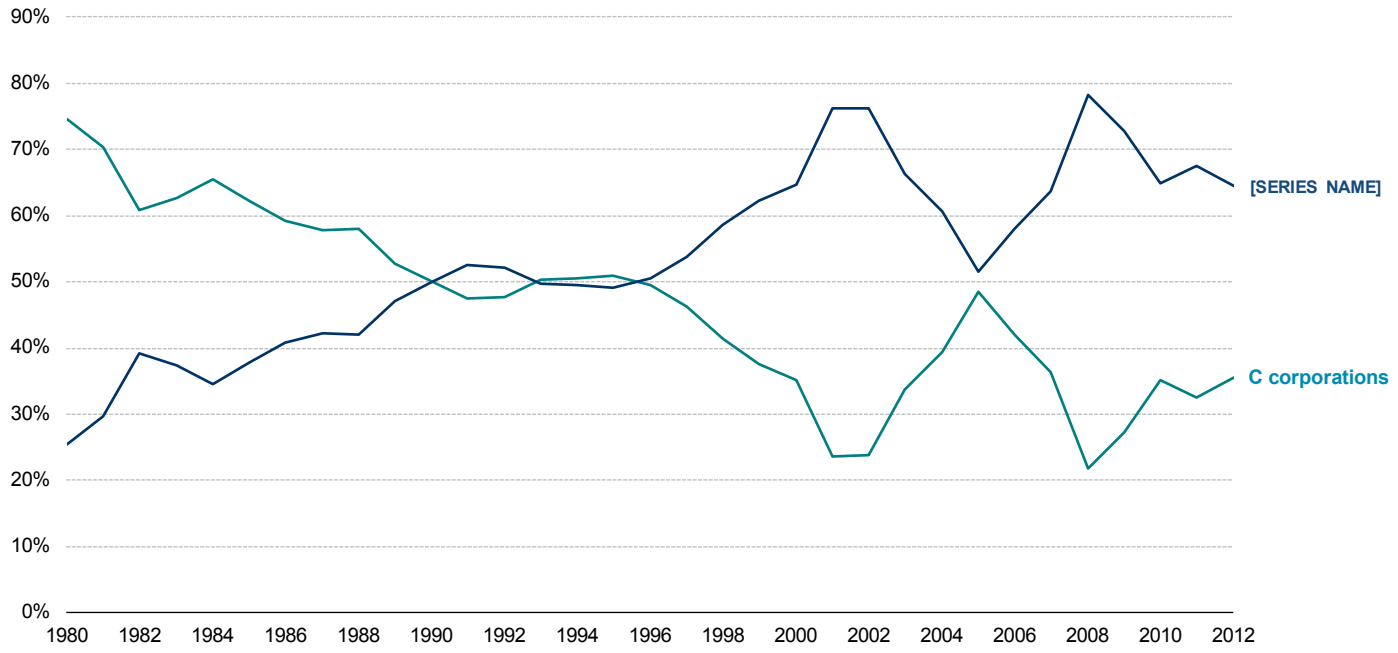
Key Elements of the U.S. Tax System

Is corporate income double-taxed?

FIGURE 1

Net Business Income (Less Deficit) as Share of Total

1980-2012



Source: IRS, Statistics of Income

In some instances, corporations can reduce the double-taxation of their income. For example, a corporation may issue debt instead of stock to finance an investment and deduct the interest payments in the calculation of taxable income. Alternatively, a corporation can retain its earnings and not pay dividends. The corporation would still pay tax on its earnings, but the shareholders would defer the second round of taxation until the corporation distributed the earnings or the shareholders sold their stock at a price that reflected the value of the retained earnings.

But these choices distort business behavior. They encourage debt financing over equity, which creates a riskier capital structure for the corporation. And they encourage a corporation to retain earnings that might better be used by its shareholders.

In addition, there often is not a second level of tax. Many shareholders, such as retirement accounts, educational institutions, and religious organizations, are exempt from income tax; the earnings distributed to these shareholders are not double-taxed. By some recent estimates, the share of U.S. corporate stock held in taxable accounts has fallen from over 80 percent in 1965 to about 25 percent today (Rosenthal and Austin 2016).

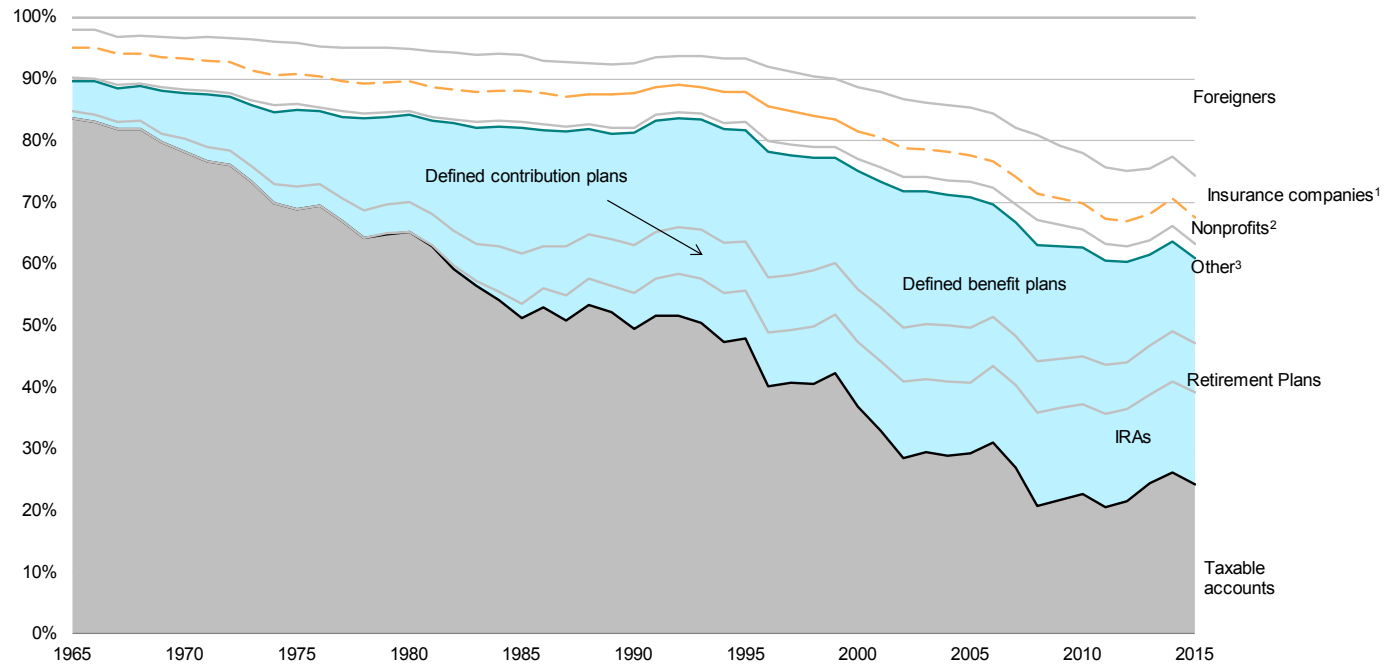
Key Elements of the U.S. Tax System

Is corporate income double-taxed?

FIGURE 2

Ownership of U.S. Corporate Stock, Direct and Indirect Holdings 1965-2015

Percent of U.S. Corporate Equity



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States;" Investment Company Institute. 2016, "The U.S. Retirement Market, Fourth Quarter 2015;" Barclay Hedge; Preqin; Tax Policy Center calculations.
(1) Stock held in non-taxable segregated reserves to fund annuity contracts and whole life insurance.
(2) Dashed lines indicate TPC estimates
(3) Primarily government holdings, but includes equities in 529 savings plans.

Many other countries have "integrated" their corporate and shareholder taxes. Some countries permit corporations to deduct the dividends they pay to shareholders. Other countries give shareholders full or partial credit for taxes paid at the corporate level, or they permit shareholders to exclude dividends from their taxable income. There are pros and cons to each approach, but one thing is clear: integrating the two taxes would cost a lot of revenue.

Data Sources

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Q. What is the New Markets Tax Credit and how does it work?

A. The credit provides an incentive for investment in low-income communities. The US Treasury competitively allocates tax credit authority to intermediaries that select in-vestment projects. Investors receive a tax credit against their federal income tax.

BACKGROUND

The New Markets Tax Credit (NMTC) was established in 2000. Congress authorizes the amount of credit authority, which is then allocated to qualified applications by the Treasury Department. Since 2003, the program has parceled out credits worth nearly $20 billion. The NMTC has supported over 4,800 projects in all 50 states, the District of Columbia, and Puerto Rico. Some 41 percent of US census tracts qualify for NMTC in-vestments. The credit expired at the end of 2014 but Congress extended the credit ret-roactively to 2015 and through 2019.

WHO INITIATES NMTC PROJECTS?

Community development entities (CDEs) are intermediaries that make loans or invest-ments. They apply to the Treasury Department's Community Development Financial Institutions (CDFI) Fund to receive tax credit authority. CDEs sell these tax credits to investors and use the funds to make debt or equity investments in entities located in qualified low-income communities. CDEs are encouraged to make deals and offer pref-erential rates and terms in areas that are more highly distressed. CDEs frequently use other public subsidies and private sector funds to invest in projects.

Many enterprises, including banks, developers, and local governments can qualify to become CDEs. The Urban Institute found in its 2013 evaluation of the first years of the New Markets program that for-profit non-financial institutions (such as developers and other private corporations) were awarded the highest share of NMTCs, followed by CDFIs and other mission-driven lending institutions. The third highest share went to for-profit financial institutions. Nonprofit nonfinancial institutions and government and quasi-government CDEs were awarded fewer and smaller NMTC allocations.

Key Elements of the U.S. Tax System

What is the New Markets Tax Credit and how does it work?

WHO INVESTS IN NMTC PROJECTS?

NMTC investors provide capital to CDEs, and are awarded credits against their federal tax obligations in exchange. Investors can claim their allotted tax credits in as little as seven years—5 percent of the investment for each of the first three years and 6 percent of the project for the remaining four years—for a total of 39 percent of the NMTC pro-ject. A CDE can be its own investor or find an outside investor. Investors are primarily corporate entities—often large international banks or other regulated financial institu-tions—but any entity or person is eligible to claim NMTCs.

WHO RECEIVES NMTC INVESTMENTS?

"Qualified active low-income businesses" (QALICBs) are the recipients of NMTC in-vestments. While called "businesses," QALICBs can be for-profit or nonprofit enterpris-es. The Urban Institute found in its 2013 evaluation that about 60 percent of projects in the first years of the NMTC program went to for-profit QALICBs, and most of the rest went to nonprofits. (The remaining 2 percent of projects were linked to tribal or other government organizations.)

The study found that QALICBs ranged in size—as measured by annual gross revenues or operating budgets at the start of their NMTC projects—from zero for start-ups to $7 billion for a large for-profit parent entity in the natural resources business, with a median of $740,000.

WHAT TYPES OF PROJECTS DOES THE PROGRAM FUND?

The NMTC program is flexible with regard to project type and purpose. QALICBs can be used to finance equipment, operations, or real estate. The real estate financing can be for the purchase or rehabilitation of retail, manufacturing, agriculture, community facili-ties (e.g., health services, museums, or charter schools), rental or for-sale housing, or combinations of these.

In its 2013 evaluation, the Urban Institute categorized project types (table 1 and figure 1). Although no project type dominated early-year projects, the most prevalent were office, retail, manufacturing/industrial, and mixed-use.

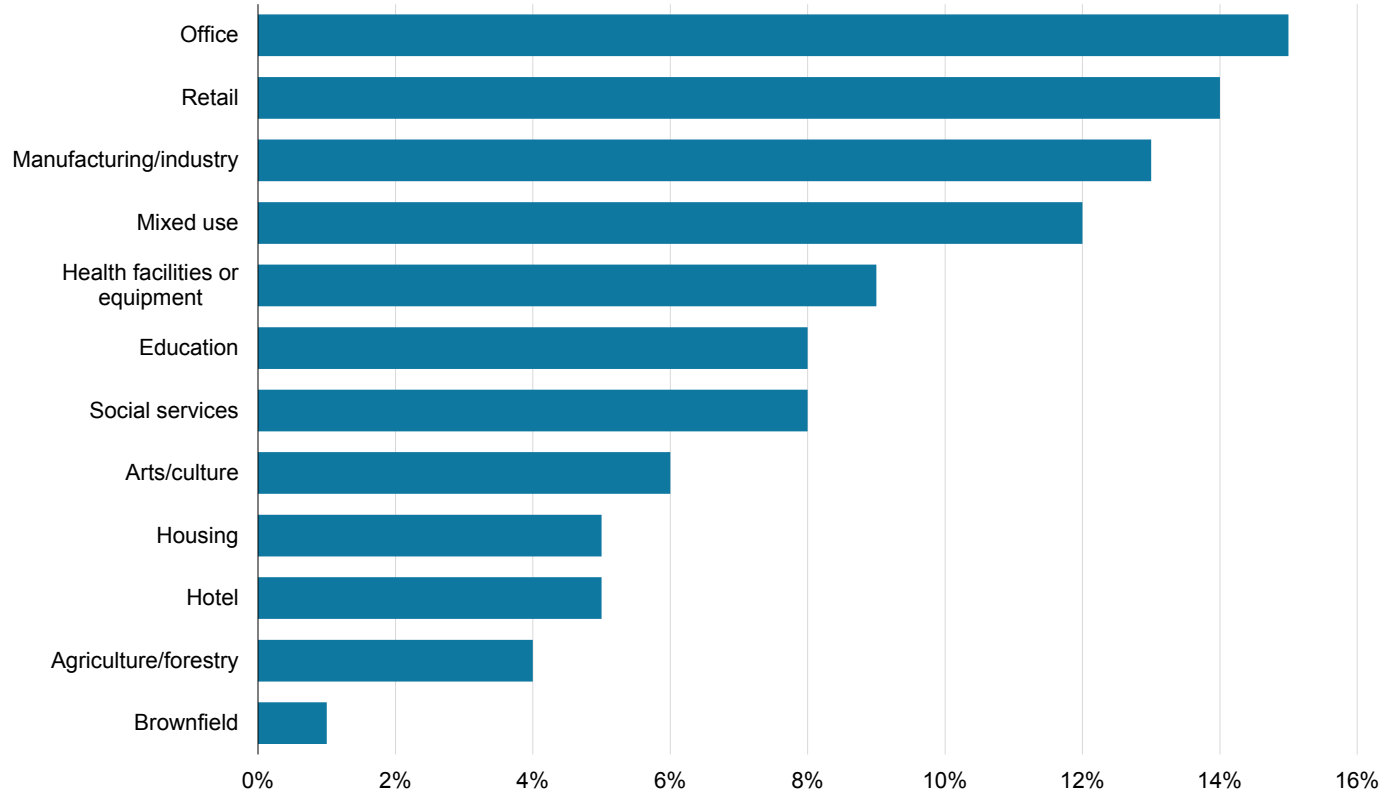
Key Elements of the U.S. Tax System

What is the New Markets Tax Credit and how does it work?

FIGURE 1

New Market Tax Credit Projects by Share

2003-2007



Source: Abravanel et al. 2013.

Further Reading

Abravanel, Martin D., Nancy M. Pindus, Brett Theodos, Kassie Dumlao Bertumen, Rachel Brash, and Zachary J. McDade. 2013. "New Markets Tax Credit Program Evaluation." Washington, DC: Urban Institute.

Q. How does the current system of international taxation work?

A. All countries tax income earned by multinational corporations within their borders. The United States also taxes the foreign-source income of US-based multinationals when it is repatriated to the US parent, with a credit for foreign income taxes they've paid. Most other countries simply exempt the foreign-source income of their multinationals.

HOW THE UNITED STATES TAXES FOREIGN-SOURCE INCOME

The federal government taxes US resident multinational firms on their worldwide income at the same rates applied to domestic firms; the current maximum tax rate—the rate that applies to most corporate income—is 35 percent. US multinationals may claim a credit for taxes paid to foreign governments on income earned abroad, but only up to their US 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 US tax due on income earned in low-tax countries.

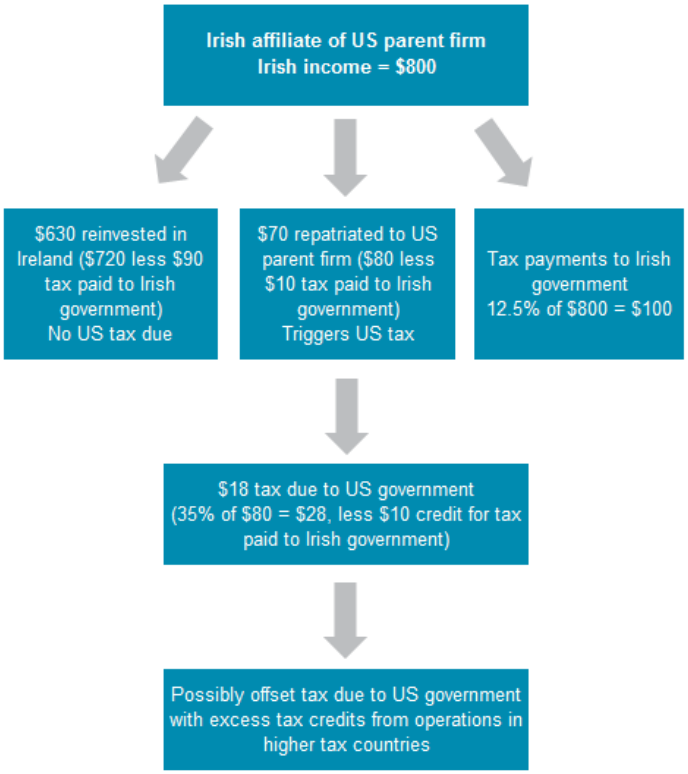
US multinationals generally pay tax on the income of their foreign subsidiaries only when they repatriate the income, a delay of taxation termed "deferral." Deferral, the credit limitation, and cross-crediting all provide strong incentives for firms to shift income from the United States and other high-tax countries to low-tax countries.

Suppose, for example, a US-based multinational firm facing the 35 percent maximum corporate income tax rate earns $800 in profits in 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 US 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 US tax of $18. If the firm has excess foreign tax credits from operations in high-tax countries, it can offset more (or possibly all) of the US tax due on its repatriated Irish profit. Meanwhile, deferral allows the remaining profit ($630) to grow abroad, free of US income tax until it is repatriated.

Key Elements of the U.S. Tax System

How does the current system of international taxation work?

FIGURE 1
Example for Taxing a US-Based Multinational Firm
2015



Most countries, including all other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom), use a territorial system that exempts most so-called "active" 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 general, an exemption system provides an even stronger incentive than the current US tax system to earn income in low-tax countries because there is no residual domestic tax due upon repatriation of foreign profits.

Most countries, including the United States, also have rules in place intended to limit the ability of their resident corporations to shift profits to low-income countries. These rules, called Controlled Foreign Corporation (CFC) rules, tax some forms of income, typically "passive income," such as interest and dividends from portfolio investments, on a current basis. In that sense, even countries with a formal territorial system use a hybrid approach that subjects some foreign-source income to domestic tax.

Because of deferral, cross-crediting, and imperfect anti-avoidance rules, US multinationals pay little residual tax on their foreign-source income, making the system arguably no less favorable to US multinationals than a territorial system with stronger CFC rules.

Key Elements of the U.S. Tax System

How does the current system of international taxation work?

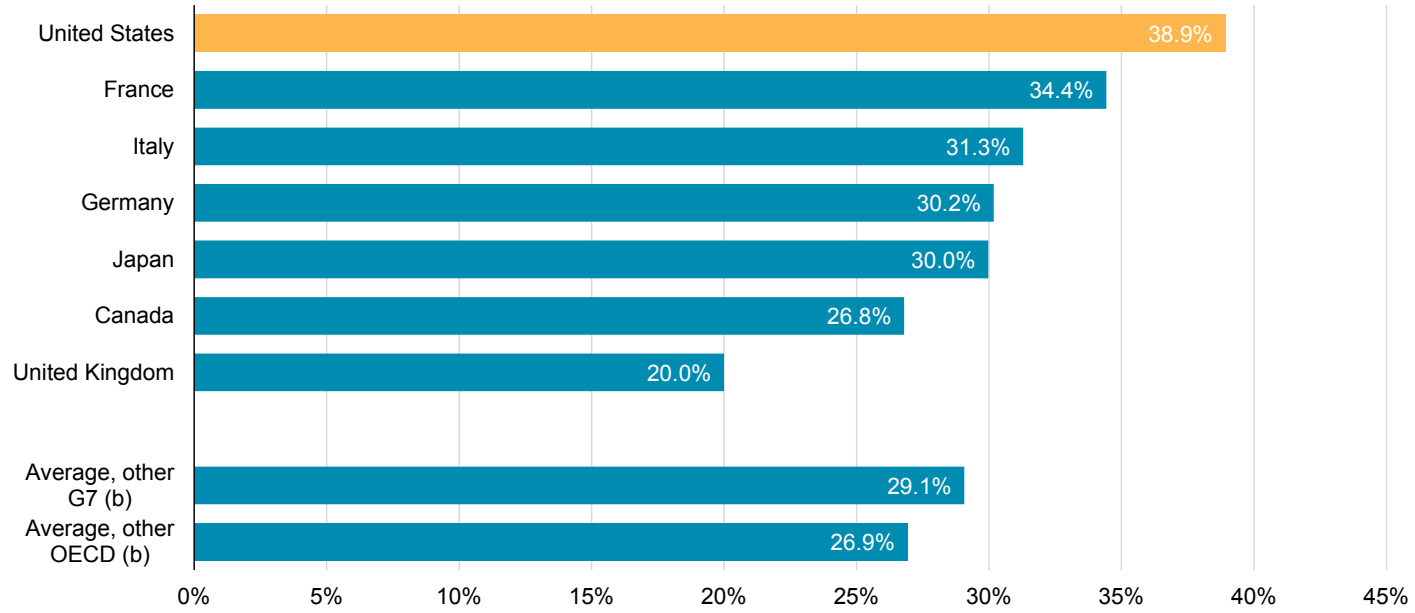
CORPORATE TAX RATES AND REVENUES

The US statutory corporate tax rate has changed little since 1986. Meanwhile, most other advanced industrial countries have lowered their tax rates. As a result, the top US corporate tax rate, including the average state corporate rate, is now higher than the top corporate tax rate of the other leading economies in the G7 and over 10 percentage points higher than the GDP-weighted average rate in the other Organisation of Economic Co-Operation and Development (OECD) countries (figure 2).

FIGURE 2

Maximum Corporate Tax Rates by Country[a]

Among leading economies, 2016



Sources: OECD (2014); TPC calculations.
(a) Includes taxes of sub-national governments.
(b) Weighted by GDP.

Despite its relatively high corporate tax rate, the United States raises less revenue from corporate income tDespite its relatively high corporate tax rate, the United States raises slightly less revenue from corporate income taxes as a share of GDP than the average of other countries in the OECD (figure 3). 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 the cuts in tax rates. In the United States, revenue has varied significantly from year to year with economic conditions and the vagaries of temporary investment incentives, but revenue has remained at slightly over 2 percent of GDP in most years since the 1980s. The Congressional Budget Office, however, projects that corporate revenues will decline to about 1.5 percent of GDP at the end of the next decade due to continued shifting of reported profits of overseas, increases in the share of business activity originated in partnerships and corporations, and the permanent extension of some corporate tax incentives that Congress enacted at the end of 2015.

US corporate tax revenues lag behind other developed countries' because of a narrower 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 and opportunities for US companies, especially those with significant assets in intangible property, to shift reported income abroad.

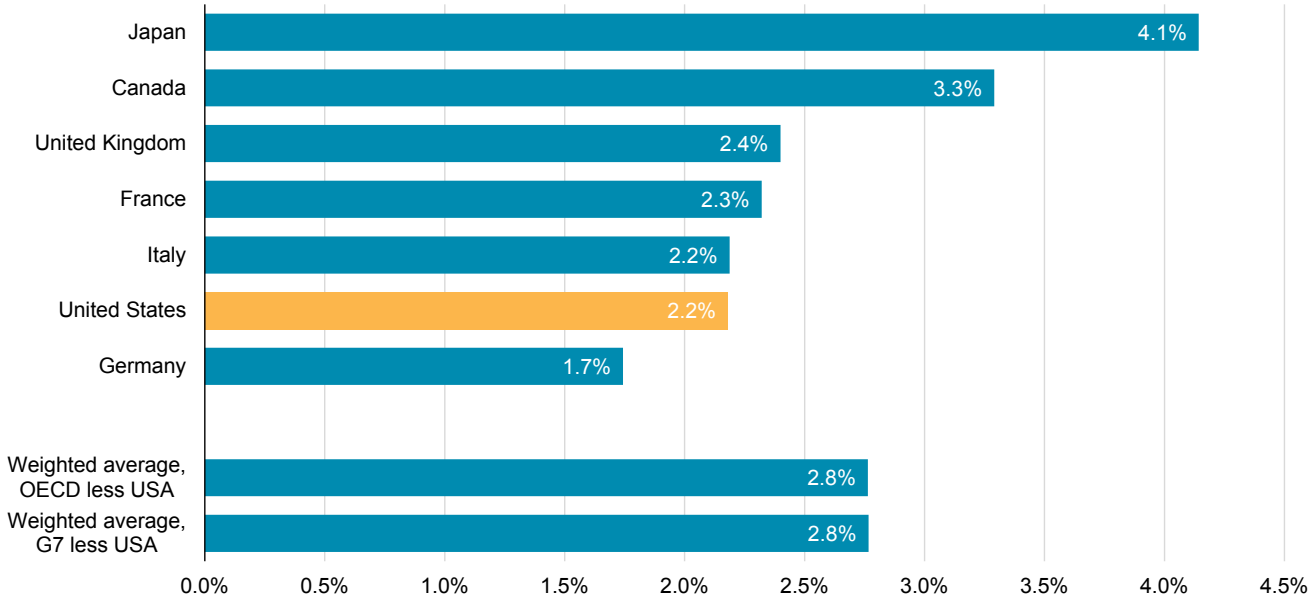
Key Elements of the U.S. Tax System

How does the current system of international taxation work?

FIGURE 3

Corporate Tax Revenue as Share of GDP by Country

Among leading economies, 2014



Sources: OECD (2014); TPC calculations.

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Q. What are the consequences of the US International Tax System?

A. Current rules encourage US multinational firms to earn and report profits in low-tax foreign countries, enable both US- and foreign-based firms to shift profits earned in the United States to other countries, and encourage companies to incorporate in foreign jurisdictions.

INCENTIVES TO EARN AND REPORT PROFITS IN LOW-TAX COUNTRIES

Multinational corporations typically operate overseas through foreign subsidiaries that are mostly taxed as independent corporate entities. This separate entity system gives multinationals incentives to shift reported profits to their affiliates in low-tax jurisdictions by underpricing sales to them and overpricing purchases from them.

For tax reporting purposes, most governments require firms to use an "arm's length" standard, setting prices for transactions within the corporate group ("transfer prices") equal to the prices that would prevail if the transactions were between independent entities. Yet ample room remains for firms to manipulate transfer prices, especially for intangible assets such as patents that are unique to the firm and for which there is no easily established market price.

Leading multinationals often shift the ownership of their intangibles, which generate a large share of their worldwide profits, to affiliates in very low tax jurisdictions, such as Ireland and Singapore. Typically, multinationals generate very little real economic activity—as measured by output, sales, or investments in plant and equipment—in these jurisdictions.

Multinationals can reduce their taxable income further through debt-equity swaps that strip profits from higher-tax countries where production facilities are located. US laws make it easier for US firms to strip profits from high-tax foreign countries than from the United States, which creates an incentive for firms to locate production facilities overseas.

US multinationals book a disproportionate share of profits in low-tax locations. In 2013, US multinationals reported over one-fourth of their overseas profits in three low-tax countries: the Netherlands, Ireland, and Bermuda (figure 1). The top ten foreign locations of their profits, including other low-tax countries such as Switzerland, Singapore, the UK Caribbean Islands, and the United Kingdom itself accounted for just over 60 percent of their non-US profits.

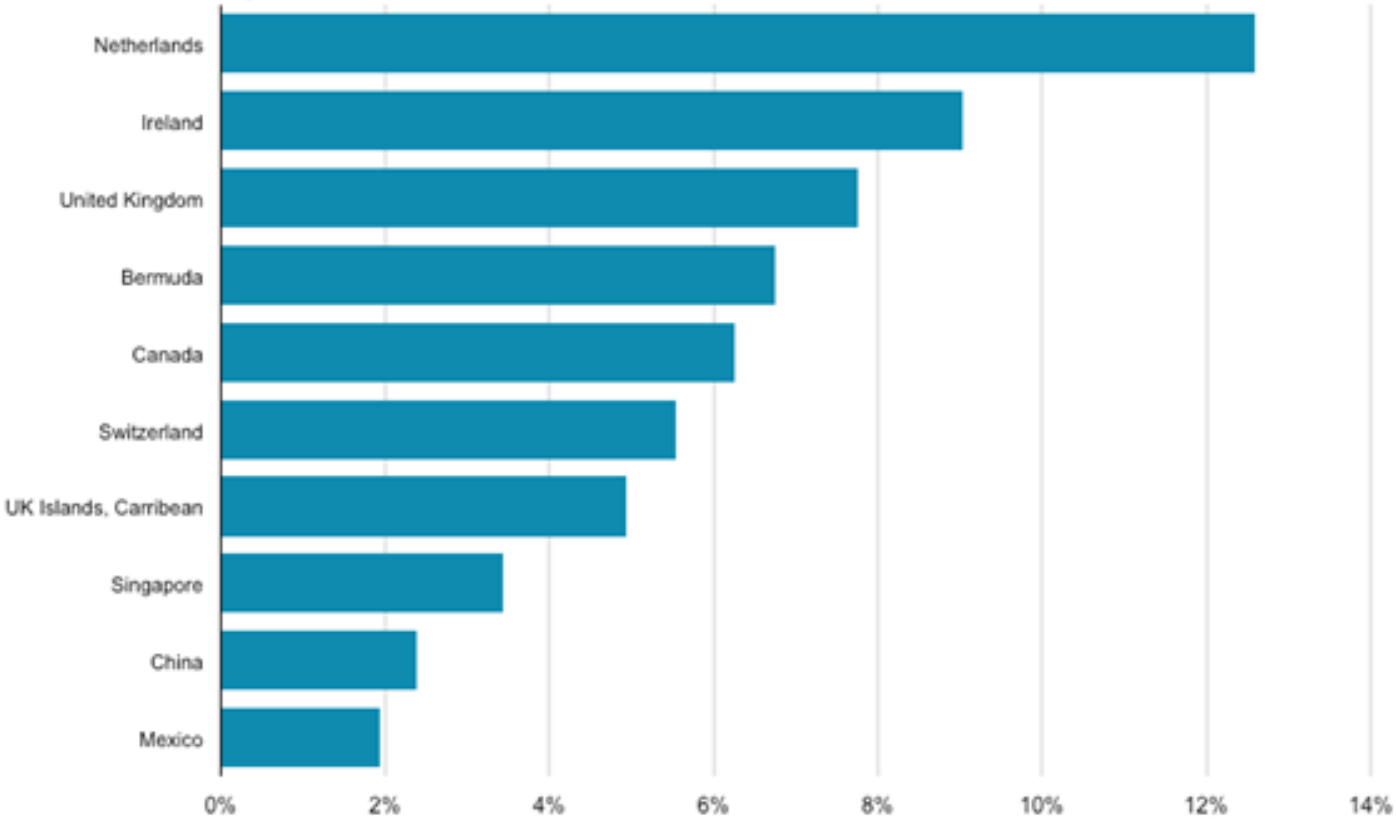
Key Elements of the U.S. Tax System

What are the consequences of the US International Tax System?

FIGURE 1

Top Countries for Non-US Profits of US Multinationals

Profits as a percentage of total, 2013



Source: Bureau of Economic Analysis, 2015.

Most of the advanced industrial countries have lowered their corporate income tax rates in recent years at least in part to attract multinational businesses, while US rates have changed little. The increasing discrepancy between US and foreign rates has strengthened incentives to shift income and has reduced US tax revenue.

Despite evidence that firms shift the location of real investment in response to tax rate differences among countries, a substantial share of real activity of US multinationals remains in high-tax countries. These tend to be large economies with close economic ties to the United States (figure 2). Although their statutory rates have declined over time while the US corporate rate has remained unchanged, some of them allow less generous rules for capital recovery than the United States. As a result, for most of these countries, their effective corporate tax rates on new investments are only slightly lower than the US rate.

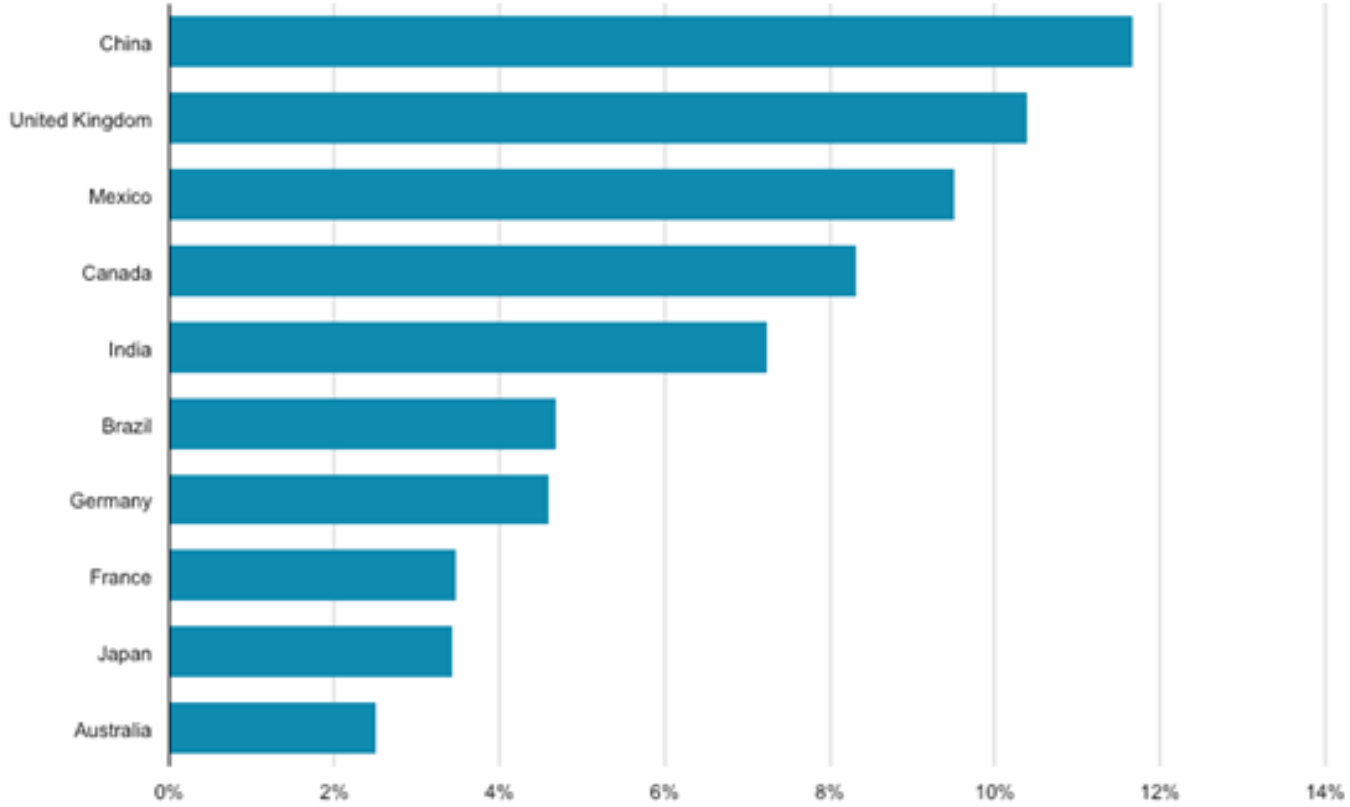
Key Elements of the U.S. Tax System

What are the consequences of the US International Tax System?

FIGURE 2

Top Foreign Locations for Employment in US Multinationals

Employment as a percentage of total, 2013



Source: Bureau of Economic Analysis, 2015.

INCENTIVES TO ACCRUE CASH OVERSEAS

The combination of deferral and increased reporting of US multinationals' income in low-tax jurisdictions has led to a large buildup of overseas assets, as many firms no longer have enough foreign tax credits to offset US taxes when they repatriate foreign profits. Recent research suggests that this "lock-out" of foreign profits is equivalent to an implicit tax of between 5 and 7 percent on foreign-source income.

INCENTIVES TO INCORPORATE OVERSEAS

The current US system treats multinational enterprises whose parent companies are incorporated in the United States (US-resident multinationals) differently from those that are resident elsewhere. The United States taxes its multinationals on dividends they receive from their foreign affiliates, while our major trading partners have so-called territorial systems that exempt these dividends. In addition, US anti-abuse rules limit the ability of US-based multinationals to use debt-equity swaps to shift reported income out of the United States but do not apply similar limits to foreign-resident multinationals. The Treasury Department (2016), however, has recently issued new regulations to deter this form of earnings-stripping.

Key Elements of the U.S. Tax System

What are the consequences of the US International Tax System?

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production is located, where its sales take place, where its shareholders reside, or even where its top managers live.

The benefits of foreign residence, combined with the lack of economic substance to the residence definition, have led some US-based multinationals to shift the formal incorporation of their parent companies overseas. This type of transaction ("inversion") can often be accomplished without changing the location of any real business activities.

Over the years, Congress has enacted rules to limit inversions. A company can still "re-domicile," though, by merging with a foreign-based company under certain conditions, including a requirement that the original foreign company contribute at least 20 percent of the shares of the new merged company if other conditions are not met.

A recent wave of inversion transactions, like previous waves, has generated considerable concern among US policymakers and led to proposals for additional limits on merger transactions. However, the formal residence of a corporation may be losing significance in an increasingly global economy where capital flows freely and a firm's research and development, production, and sales are often spread worldwide. The location of investment, jobs, research and development, and tax revenue matter more than the site of a multinational firm's parent company, although corporate residence does have some effect on US tax revenues and arguably may matter for research and development and other high-value activities often associated with a company's headquarters.

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Q. How does the tax system affect US competitiveness?

A. The international tax policies that best encourage firms to invest in the United States are not necessarily the policies that best help US multinational companies compete with foreign-based multinationals. Policymakers face a trade-off among goals.

WHAT IS COMPETITIVENESS?

Many—really all—politicians favor "international competitiveness," but the term means different things to different people. To some, it is the ability of domestic firms or industries to compete with their foreign counterparts in a global marketplace. For them, this translates into support for "mercantilist" policies that seek to increase exports, reduce imports, or promote more US activity in certain sectors, such as manufacturing.

An alternative form of mercantilism seeks to promote the growth of a country's resident multinational corporations without regard to whether they produce at home or overseas. Concerns about the competitiveness of US multinationals often follow from an assumption that these firms generate spillover benefits for the economy in which they are headquartered. For example, the knowledge created by the research and development (R&D) that these firms conduct (typically at headquarters) often gets diffused to other domestic producers, boosting their competitiveness.

By contrast, many economists view free trade and capital movements as mutually beneficial because they tend to raise living standards in all countries. These economists define "competitive" policies as those that increase the standard of living of Americans over the long run, without regard to their effects on the balance of trade, the net direction of international capital flows, or success in expanding specific activities, such as manufacturing or R&D.

Global international tax practices seek to promote free capital movements by preventing double taxation of international capital flows. These same practices assign rights to tax profits to the capital-importing countries (i.e., the country where production facilities are located).

The capital-exporting country has two ways to avoid double taxation. The first is simply to exempt taxation of the foreign-source income of its residents. The second is to tax the worldwide income of its residents but to allow credits for foreign income taxes they pay so that their income is taxed at the home-country rate rather than the rate in the country where the income is earned. These two approaches have very different implications for a country's attractiveness as a location for productive investment or as a place for multinational corporations to establish residence.

Key Elements of the U.S. Tax System

How does the tax system affect US competitiveness?

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.

TAX POLICIES TO ATTRACT INVESTMENT

The US corporate tax system discourages investment in the United States by both US- and foreign-based corporations because the top corporate tax rate in the United States (if state-level taxes are included) is higher than the top corporate tax rate in all of our major trading partners. However, this disadvantage to US investment is partially offset by capital recovery provisions that are more generous in the United States than in many other countries and by provisions that make it easier in the United States than in most other countries to establish businesses whose owners benefit from limited liability without being subject to corporate-level taxation.

The US tax system also encourages US-based multinationals to invest overseas instead of at home because US multinationals can defer US tax on the income of their foreign-owned subsidiaries in low-tax countries until that income is repatriated to the US parent firm. The effects of this incentive for foreign investment are partially offset, though, if the shift of investment overseas by US multinationals raises pre-tax returns on investment in the United States and thereby encourages an inflow of capital from foreign-based firms.

TAX POLICIES TO ATTRACT CORPORATE HEADQUARTERS

The US tax system arguably places US multinationals at a competitive disadvantage with foreign-based multinationals with income from low-tax countries because US companies must pay the difference between the US tax rate and foreign tax rates when they repatriate profits from their foreign affiliates. In contrast, most countries in the Organisation for Economic Co-operation and Development and all the other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom) have exemption systems that allow their resident multinationals to pay only the foreign-tax rate on their overseas profits.

In addition, the US controlled foreign corporation (CFC) rules tax some forms of foreign-source income of US multinationals as it accrues in their foreign subsidiaries. The goal is to prevent schemes that strip reported profits from US tax jurisdiction to low-tax foreign countries. The CFC rules, however, only apply to US-resident multinationals and do not prevent similar schemes by foreign-resident multinationals to strip profits from their US affiliates.

Others argue that US multinationals are not, on balance, put at a disadvantage by the US tax system. They point to the ability of US companies, especially those with significant assets in intellectual property, such as firms in the high-tech and pharmaceutical sectors, to shift reported profits to low-tax jurisdictions. They also note that since 1997, "check-the-box" regulations have effectively enabled US multinationals to shift reported profits from production in high-tax foreign jurisdictions to tax havens without being subject to US CFC rules.

WOULD A VALUE-ADDED TAX INCREASE US COMPETITIVENESS?

Some commentators argue that substituting a value-added tax (VAT) for all or part of the corporate income tax would improve the US trade balance because, unlike the corporate income tax and other levies imposed on income earned in the United States, VATs typically exempt exports and tax imports.

But most economists dispute the claim that a VAT would improve the trade balance, arguing that any benefit to net exports from a VAT would be offset by a resulting appreciation of the US dollar relative to other currencies. In fact, some research suggests that countries that rely heavily on VATs for revenue have lower net exports than those that don't.

Replacing some or all of the corporate income tax with a VAT would, however, affect the trade position of some industries relative to others. Exemptions and lower rates within a VAT affect the relative prices consumers pay for different goods and services but do not distort trade patterns because VAT burdens do not depend on where goods and services are produced. In contrast, preferences within the corporate income tax do affect production location, improving the competitiveness of some US producers while worsening the competitiveness of others because the tax does affect relative costs of production.

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Q. How would formulary apportionment work?

A. Under the current global system, multinational firms determine their profits separately in each tax jurisdiction in which they operate. A system that apportioned profits by formula would allocate a firm's worldwide income across countries based on its sales, assets, and payroll in each jurisdiction.

HOW IT WORKS

Under formulary apportionment, a multinational corporation would allocate its profits across countries based on its sales, payroll, and capital base in each jurisdiction. It would pay domestic corporate taxes on the share of its worldwide income that is allocated to each jurisdiction. An alternative would base a corporation's taxes only on the fraction of its worldwide sales destined for domestic consumers, a so-called "destination-based" corporate profits tax.

Many states in the United States use a formulary apportionment system to determine their taxable share of US-source corporate profits. The formulas have been historically based on a weighted average of the shares of sales, payroll, and assets in the state. But recently, some states have shifted to a sales-only apportionment system in order to remove any incentive to shift employees or facilities to other jurisdictions.

The adoption of formulary apportionment by states 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 by an affiliate in one state and how much by an affiliate in another.

ADVANTAGES OF FORMULARY APPORTIONMENT

Formulary apportionment would remove the current artificial incentive for multinationals to shift reported income to low-tax locations because tax liabilities would be allocated by 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 division of profits among separate entities within a firm.

Formulary apportionment would also 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 for tax purposes. There would no longer be a need for controlled foreign corporation rules because all profits assigned to foreign activities would be exempt. For this reason, there would also no longer be a need for foreign tax credits, so firms would have no incentive to manage profit repatriation to maximize the availability of offsetting tax credits. Because intra-firm transactions would not affect the measure of domestic profits, there would be no need for transfer-pricing rules for intra-firm transactions, which would remove a major source of dispute between corporations and tax authorities.

The United States and other high-tax countries would gain substantial revenue under formulary apportionment because firms' shares of real economic activity in these countries typically exceed the shares of income they now report as originating there. The move to formulary apportionment could therefore be made revenue-neutral by substantially reducing corporate tax rates. Moreover, because it would make a multinational corporation'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 inversions in which firms from two countries merge to move around their tax liabilities.

PROBLEMS AND DISADVANTAGES

Formulary apportionment would require an agreement among the major economies to scrap the current separate-entity system and to agree on how to allocate corporate income among jurisdictions. It would also require agreement on common accounting methods for measuring corporate profits.

A unilateral move by the United States to formulary apportionment would result in double taxation of some income of multinationals and exemption of other income. That's because different countries would use radically different methods of allocating income among jurisdictions.

A formulary apportionment system would introduce new boundary problems between high-tax and low-tax activities. While the current separate-entity system creates incentives to shift reported profits among separate firms within a multinational corporation, formulary apportionment provides incentives to shift profits between multinationals and separately owned firms. For example, if physical assets are one of the determinants of the location of a multinationals' profits, a firm might well have an incentive to contract out its manufacturing to independently owned firms in high-tax jurisdictions instead of establishing a manufacturing subsidiary within the firm.

Formulary apportionment does not provide an answer to how to locate a firm's intangible assets, which are a significant share of the value of some of the leading multinationals, especially in the high-tech and pharmaceutical sectors.

Some analysts and commentators favor sales- or destination-based allocation of corporate profits because firms are least likely to reduce sales in a jurisdiction simply to reduce tax liability. A problem with a sales-based allocation, however, is that multinationals can then avoid tax on the profits from their intangible assets by selling their products to independent distributors in low-tax countries, who would then resell them throughout the world. Although rules could be written to prevent abuses of this type, they would be cumbersome and hard to enforce because most of the output of multinationals is sold primarily to other companies in complex supply chains rather than directly to final consumers.

How would formulary apportionment work?

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Q. What are inversions, and why do they happen?

A. An inversion is a transaction in which a US-based multinational company merges with a smaller foreign company and then establishes a foreign residence. As a foreign resident, the company can significantly reduce its taxes without changing the location of any real business activities.

The current US system treats multinational enterprises whose parent companies are incorporated in the United States (US-resident multinationals) differently from those that are resident elsewhere. The United States taxes its multinationals on dividends they receive from their foreign affiliates, while our major trading partners have so-called territorial systems that exempt these dividends. In addition, US anti-abuse rules limit the ability of US-based multinationals to use debt-equity swaps to shift reported income out of the United States, but do not apply similar limits to foreign-resident multinationals.

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production is located, where its sales take place, where its shareholders reside, or even where its top managers live.

The tax benefits of foreign residence, combined with the residence definition's lack of economic substance, have led some US-based multinationals to shift the formal incorporation of their parent companies overseas. This type of transaction ("inversion") can often be accomplished without changing the location of any real business activities. Some recent research (Rao 2015), however, finds that inverted companies over time increase their shares of employees and investment overseas compared to companies that did not invert.
In recent years, US multinationals have accumulated a large amount of un-repatriated foreign cash, increasing the motivation for inversion transactions (Clausing 2014). The shift of reported income to low-tax foreign countries is responsible for much of the accruals. As a result, taxes on dividends paid back to the US parent will not be shielded by foreign income tax credits.

Over the years, Congress has enacted rules to limit inversions. Simple inversions—a US company establishes a foreign affiliate, which then becomes the parent company—no longer work because the United States would continue to treat the new company as US resident. A company can still "re-domicile," though, by merging with a foreign-based company under certain conditions; these include a requirement that the original foreign company contribute at least 20 percent of the shares of the newly merged company if other conditions are not met.

Key Elements of the U.S. Tax System

What are inversions and why do they happen?

A recent wave of inversion transactions, like previous waves, has generated considerable concern among US policymakers and has led to proposals for additional limits on merger transactions. Legislative proposals that have recently been considered in Congress and discussed in the Presidential campaign would have required that the original foreign company contribute at least 50 percent of the shares of the merged company, would have placed new limits on interest deductions by US subsidiaries of foreign multinationals to prevent income stripping through debt-equity swaps, and would have imposed a one-time exit tax on the accrued foreign profits of inverting companies (Rosenthal 2015). In addition, the Treasury in 2014 issued new regulations to prevent ways of avoiding the 20 percent threshold on foreign ownership and to make it more difficult for the newly merged companies to repatriate earnings they accrued prior to the merger tax-free.

In 2016, Treasury issued additional regulations (U.S. Treasury Department, 2016) that used its current authority (Shay, 2014) to reclassify certain debt transactions between related parties as equity instead of debt to deter income stripping by foreign-based multinationals. These regulations are controversial and may not survive the change in Administration following the 2016 Presidential election.

New proposed anti-inversion legislation could stem the latest types of inversions, as past legislation halted earlier transactions. Changes in the residence of existing US corporations, however, are not the only way the share of world output by US-based multinationals can decline over time. Foreign-based multinationals can purchase smaller US companies or divisions of larger ones. New companies can be chartered overseas instead of in the United States. And foreign-based multinationals can expand faster than US-based companies if US tax laws place US multinationals at a disadvantage. In the long run, new limits on inversions, like previous ones, may be ineffective if tax laws continue to place some US-resident companies at a disadvantage compared with foreign-resident companies.

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Q. What are the options for reforming our international tax system?

A. On its face, reforms that would remove the incentive for US corporations to move abroad and lower corporate tax rates to make US corporate activity more competitive seem straightforward. In fact, unraveling the Gordian knot created by taxation-as-usual would be far from simple.

FLAWS OF CURRENT US INTERNATIONAL TAX RULES

There's seemingly no end to complaints about the impact of the US corporate tax in the context of an increasingly integrated global economy. Among them are the following:

- Deferral of foreign-source income until it is repatriated encourages multinationals to locate business activity and to report profits in low-tax countries.
- The taxation of foreign-source income of US-based firms when repatriated, along with the controlled foreign corporation (CFC) rules that tax some foreign-source income as it is accrued, place US-resident multinationals at a competitive disadvantage with firms resident in countries that exempt most foreign-source income and have weaker CFC rules.
- The timing of tax liability when income is repatriated, combined with rules that allow US firms to report their accumulated foreign profits as permanently invested overseas, have in recent years encouraged US resident multinationals to accumulate substantial assets abroad, some of which could be more effectively deployed if invested in the United States or paid as dividends to shareholders.
- The complexity of the various rules apportioning income by jurisdiction and preventing tax avoidance by limiting deferral and the use of offsetting foreign tax credits raise compliance costs. Yet they still offer substantial opportunities for legal tax avoidance.
- Taxes on foreign-source income of US multinationals raise relatively little revenue, even though the US corporate tax rate exceeds the tax rate in other countries in which US firms report profits.

REFORM OPTIONS: ELIMINATE DEFERRAL

Eliminating the deferral of US tax liability on the non-repatriated foreign-source income of US-based multinationals would increase revenue and substantially reduce firms' incentives to earn income in (or to shift profits to) low-tax countries. However, eliminating deferral could put US-based multinationals at an additional competitive disadvantage by raising the tax rate they pay on income earned in low-tax countries compared with taxes paid by foreign-based multinationals. And that, in turn, would create greater incentives for US firms to change their tax residence through mergers with foreign-based firms.

Key Elements of the U.S. Tax System

What are the options for reforming our international tax system?

Congress could enact additional rules to discourage these "inversion" transactions. But they could not foreclose every option that allows US firms to shift corporate activity to foreign-resident multinationals.

Competitiveness concerns could be allayed, but only in part, by combining the elimination of deferral with a large (but still revenue-neutral) reduction in the US corporate income tax rate. Indeed, that is the centerpiece of tax reform plans introduced by Senate Finance Committee ranking Democrat Ron Wyden along with current and former Republican senators Dan Coats and Judd Gregg. It would have eliminated deferral while substantially reducing the top corporate tax rate.

REFORM OPTION: TERRITORIAL SYSTEM

A territorial system would exempt the foreign income of US multinational firms from US taxation. Such a system would likely enhance the competitiveness of US-based multinationals compared with foreign-based firms and reduce (but not entirely eliminate) the incentive for inversions.

The most important argument against a territorial system is that by exempting foreign income, it would reinforce the already strong tax incentive to locate economic activity and to report profits in low-tax countries. Such tax-motivated changes in behavior are generally economically inefficient and could further erode the US corporate income tax base.

That's a fair point: Depending on its design, a territorial system could bring in less tax revenue than the existing system. Harry Grubert and John Mutti (2007) have suggested, however, that revenue could actually increase under a territorial system if royalty income from abroad were defined as domestic-source income and interest allocation rules were changed.

A territorial system could simplify taxation of international income because exempting foreign income from taxation would reduce the sort of tax planning now needed to optimize the use of foreign tax credits to shield repatriated foreign income from US taxes. However, under the new system, firms would still have to distinguish between foreign and domestic income, identify passive income that is subject to CFC rules, and appropriately allocate expenses to their operations in different countries. In addition, the stronger incentives to shift income produced by eliminating the repatriation tax would further strain the rules in place to prevent bogus profit shifting through inappropriate transfer pricing.

REFORM OPTION: HYBRID SYSTEM

President Obama and congressional leaders from both parties have proposed variants of a "hybrid" system that would continue to impose a lower effective tax rate on foreign-source income than domestic-source income of US multinationals but eliminate the tax on repatriated profits. These proposals, while different, have three main elements in common:

- They would eliminate taxation of repatriated foreign-source profits of US multinational corporations.
- They would impose a one-time transition tax on currently accrued overseas profits of US multinationals, to be collected over several years.
- Going forward, they would impose a low rate tax on accrued foreign-source "intangible" profits of US multinationals in order to discourage the sort of income-shifting to low-tax countries that a pure territorial system would encourage.

On the plus side, the hybrid proposals would remove the incentive for US corporations to accrue assets overseas by eliminating taxation upon repatriation. But they would not resolve the tension between reducing the incentive for US companies to invest and report income overseas and improving the competitiveness of US-based multinationals. Depending on design details, a proposal in this form could either raise or lower the effective tax rate on foreign-source income.

REFORM OPTION: DESTINATION-BASED TAXES

A more fundamental reform option would replace the current corporate income tax with a destination-based tax. A destination-based tax is based on where a corporation's products are purchased rather than where they are produced, where the corporation is located, or where the corporation records its income. The major benefits of a destination-based tax from an international point of view is that it would eliminate incentives under the U.S. corporate income tax for firms to invest and report income overseas instead of at home and eliminate incentives for U.S. firms to "re-domicile" themselves as foreign-based firms.

Some examples of destination based taxes are a value added tax (VAT) or a business cash-flow tax. Under a VAT, border adjustments would impose the tax on imports but exempt exports by rebating any VAT previously collected at earlier stages of production. Under a destination-based business cash-flow tax border adjustments would exempt export sales from tax and not allow firms to deduct the cost of imports. The destination-based cash flow tax, however, raises its own issues, including whether the border adjustments would be acceptable to the World Trade Organization and whether it would be politically feasible to pay large rebates to export firms who would experience tax losses under the plan and impose large new taxes on importers.

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How Could We Improve the Federal Tax System?

Q. What are 10 ways to simplify the tax system?

A. The individual income tax imposes complexity that costs not only taxpayers, who expend time and money preparing and filing their returns, but also the IRS, which is responsible for auditing those returns and dealing with taxpayer errors. Here are 10 things Congress could do to simplify the income tax and reduce costs significantly for both taxpayers and the IRS.

1. **Modify or repeal the alternative minimum tax:** Originally designed to ensure that high-income households paid at least some income tax, the alternative minimum tax (AMT) now affects nearly 5 million filers, most of whom already pay significant amounts of income tax and are far from the top of the income distribution. Congress raised the AMT exemption and indexed both the exemption and other relevant parameters for inflation in 2012, but did not fix the AMT's basic problems. Modifying the AMT so that it only affects higher-income taxpayers who would otherwise pay little tax would return the tax to its original purpose. But it would hardly make the tax system simpler for those still subject to it. Repealing the AMT would both simplify the income tax and eliminate the need for annual patches, but revenue would decrease by roughly $30 billion annually.
2. **Eliminate or align income limits and phaseouts:** Many preferences in the tax code are denied to higher-income taxpayers or phased out over different ranges of income. These inconsistencies complicate tax returns; several worksheets are required to calculate taxable income, deductions, and credits. For example, the tax code reduces the $1,000-per-child credit by 5 percent of adjusted gross income (AGI) over $110,000 for married couples ($75,000 for single parents and $55,000 for married couples filing separately); the share of expenses allowed for the child and dependent care credit falls from 35 percent to 20 percent as AGI increases from $15,000 to $43,000; and the deduction for interest paid on student loans phases out for single taxpayers with modified AGI above $65,000 ($135,000 for joint filers). Eliminating such restrictions would simplify tax filing, but the benefits would go to higher-income taxpayers. Retaining income limits on tax preferences but setting them at uniform levels (at least for related activities), would reduce complexity while still focusing benefits on taxpayers with low-to-moderate incomes. Note, however, that if multiple benefits phased out over the same income range, effective marginal taxes in that range could reach unacceptably high rates.

How Could We Improve the Federal Tax System?

What are ten ways to simplify the tax system?

3. **Consolidate tax benefits for education:** Families with students in college may qualify for multiple tax benefits to defray educational expenses, but often may claim only one of them. For example, a family may be able to claim either the American opportunity credit or the lifetime learning credit, but not both, for the same student. If the family supports more than one student, it may claim one credit for one student and the other for the second student. Determining which alternative is best requires multiple calculations and can conflict with other tax benefits for education, such as Coverdell savings accounts and 529 savings plans. Combining or at least coordinating the various tax benefits would help taxpayers both determine their eligibility for benefits and calculate them.
4. **Coordinate tax benefits for dependent care:** Taxpayers may reduce the net cost of dependent care through the child and dependent care credit and through flexible spending accounts set up by their employers. They may, however, use only one of the two options for a specific expense, which can make both planning how to finance childcare and completing tax returns difficult. Coordinating the two benefits or combining them into a single benefit would address both problems.
5. **Simplify or eliminate the taxation of Social Security benefits:** Whether and how much of a recipient's Social Security benefits are subject to tax depends on income: single beneficiaries with adjusted incomes below $25,000 ($32,000 for couples) pay no tax on their benefits; those with higher incomes must include up to 85 percent of their Social Security payments in taxable income. Determining the amount to include requires completing a 19-line worksheet that draws on information from other parts of the tax return. Making a fixed fraction of benefits taxable (possibly zero) for all beneficiaries would eliminate that worksheet and make tax filing easier.
6. **Simplify the taxation of capital gains and dividends:** The income tax currently imposes many different tax rates on capital gains and dividends, depending on the taxpayer's regular tax rate, the type of asset, how long an asset was owned before it was sold, whether dividends are "qualified," and whether the taxpayer owes AMT. The IRS provides four different worksheets, one with 45 lines, to help taxpayers calculate their tax on capital gains and dividends. Allowing a percentage exclusion for qualified dividends and long-term gains (and perhaps other kinds of gain) and applying regular tax rates to the rest would sharply reduce the complexity of returns while maintaining different effective tax rates on different kinds of gains and dividends.
7. **Combine tax incentives for retirement saving:** Workers can currently save for retirement in various ways that receive different tax treatment—among them deductible, nondeductible, and Roth individual retirement accounts; regular and Roth 401(k)s and similar plans; and traditional employment-based pension plans. Each type of saving has its own eligibility requirements, income limits, and tax benefits, which complicates the task of deciding how best to save for retirement. Combining existing options into fewer alternatives and setting the same income limits for all would simplify workers' choices and reduce the cost of administering multiple programs.
8. **Consolidate programs benefiting households with children:** Personal exemptions, the child tax credit, and the earned income tax credit (EITC) all provide benefits for households with children. But each imposes different restrictions on participation, offers varying benefit levels, and requires beneficiaries to complete separate parts of tax returns. Combining all three benefits into a single refundable credit would both simplify tax filing and coordinate benefits. It could be difficult, however, to design a simple single credit that would approximate current benefits.

How Could We Improve the Federal Tax System?

What are ten ways to simplify the tax system?

9. **Simplify the earned income tax credit:** Claiming the EITC currently requires completing a three-page worksheet to determine eligibility, and then a second worksheet to calculate the credit itself (though taxpayers may elect to have the IRS complete the second task). That complexity results from strict definitions of which children qualify, different credit rates and income limits depending on the number of children, and different accounting for different kinds of income. Relaxing the requirements and making the parameters the same across taxpayers with different characteristics could reduce complexity. But this would also limit flexibility in adjusting benefits to perceived need.
10. **Use a single definition of "child":** Various income tax benefits are targeted at families with children. But the definition of "child" differs widely, particularly with respect to age. Children under age 19 (or under 24 and a full-time student) count in defining EITC benefits; those under 17 qualify for the child credit; and only those under 13 are eligible for the child and dependent care credit. Although these differences may result from deliberate congressional choices about who should receive benefits, they complicate tax filing and can lead to filing errors that the IRS has to correct. Other factors further complicate eligibility determination, including the child's physical residence, custody arrangements, and who pays the child's living costs. Establishing a single definition to determine whether taxpayers may claim tax benefits for children would simplify both tax filing and IRS processing of returns.

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Q. How might low- and middle-income households be encouraged to save?

A. Expanding access to savings vehicles and scaling back deductions to provide greater incentives to low- and middle-income households could make a difference.

HOMEOWNERSHIP

Credits to encourage homeownership can take different forms. They can provide an up-front credit for first-time homebuyers of primary residences, similar to a temporary credit employed as a stimulus measure from 2008 to 2009. (An early version of this credit served as an interest-free loan to be paid back to the IRS.) Alternatively, homeowners could receive smaller annual credits proportional to their home equity, up to a designated maximum. Another approach is to provide a credit against property taxes paid on a home to defray a significant cost of homeownership. Reforms that reward building equity instead of subsidizing mortgage interest (which a badly designed credit could also do) would encourage actual saving instead of the acquisition of debt.

RETIREMENT

A saver's credit is available to moderate-income taxpayers who contribute to qualified retirement plans. However, the credit is nonrefundable and phases out quickly at higher levels of income, making few people eligible for the maximum amount. Some economists have proposed expanding the credit and making it refundable, so that workers with no net income tax liability could claim it. More expansive proposals include reshaping the complicated pension landscape to simplify plans and increase access to employer-based retirement accounts with automatic enrollment. Contribution limits to tax-favored accounts would be lowered, and low- and moderate-income workers would instead receive government matches on their contributions. Any credits or matching employer contributions could not be accessed until retirement. Pension antidiscrimination rules could be revised to favor plans that support a larger percentage of full- and part-time employees.

How Could We Improve the Federal Tax System?

How might saving be encouraged for low-and middle-income households?

ENCOURAGE SAVINGS AND ACCOUNT OWNERSHIP AT TAX TIME

Many low- and middle-income workers receive large refunds at tax time from refundable tax credits. A "saver's bonus" could be offered to encourage taxpayers to save a portion of their refunds in qualified savings accounts. Taxpayers are already able to contribute to individual retirement accounts until the tax filing deadline and apply any deductions or saver's credits against their tax year's liability. Some tax preparers and tax preparation software remind taxpayers that they are able to do this and make clear how much tax they can save if they do. Tax time could also be used to link taxpayers to savings vehicles, such as children's savings accounts or prepaid cards with savings features for taxpayers without bank accounts.

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Q. How might we improve the AMT?

A. Congress could retarget the AMT to its original purpose or enact a major overhaul of the income tax system, eliminating the need for an alternative tax.

REFORM OPTIONS

The Family Fix

The regular income tax allows a personal exemption of $4,050 (in 2017, indexed for inflation) for each family member. The individual alternative minimum tax (AMT) exemption varies by filing status but does not increase with family size. One possible reform option, a "family fix," would allow dependent exemptions under the AMT. To mitigate marriage penalties, the proposal would also set the AMT exemption, 28 percent bracket threshold, and exemption phase-out threshold for married couples at twice the value for singles. This option would cost $172.7 billion over 10 years (figure 1) and would reduce the number of AMT taxpayers by more than 3.5 million (figure 2).

The Deduction Fix

Another option, a "deduction fix," would allow state and local taxes, miscellaneous ex-penses above the 2 percent of adjusted gross income floor, and the standard deduction to be allowable under the AMT. This reform option would cost $352.6 billion over 10 years and would reduce the number of AMT taxpayers to about 400,000.

Taxing Capital Gains

Under current law, capital gains and qualified dividends generally receive the same preferential treatment under the AMT and the regular income tax. A third option would tax capital gains and qualified dividends at the same rate as ordinary income under the AMT. This option would generate $268 billion over 10 years and would increase the number of AMT taxpayers by about 1 million annually.

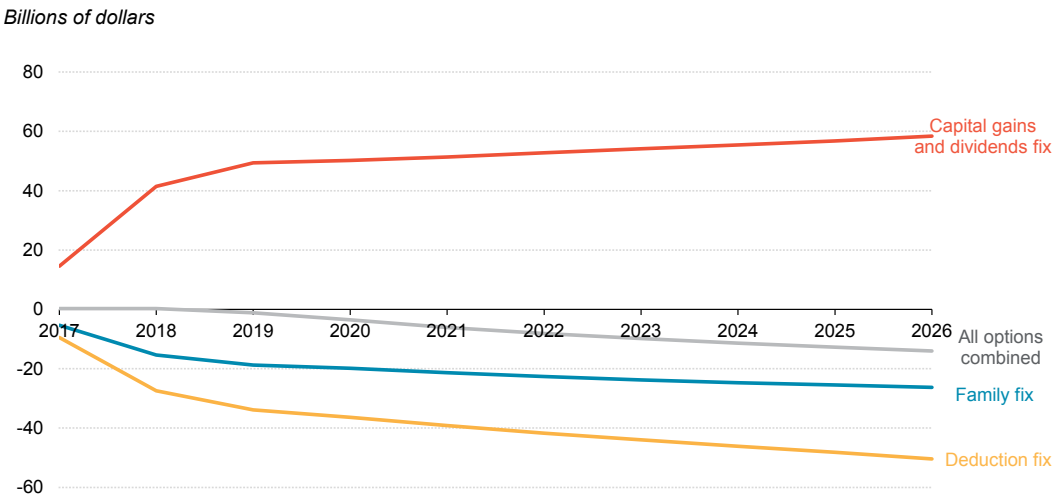
A major AMT overhaul combining all three of the above options would cost $229.5 bil-lion over 10 years, and would decrease the number of AMT taxpayers to about 500,000.

How Could We Improve the Federal Tax System?

How might we improve the AMT?

FIGURE 1

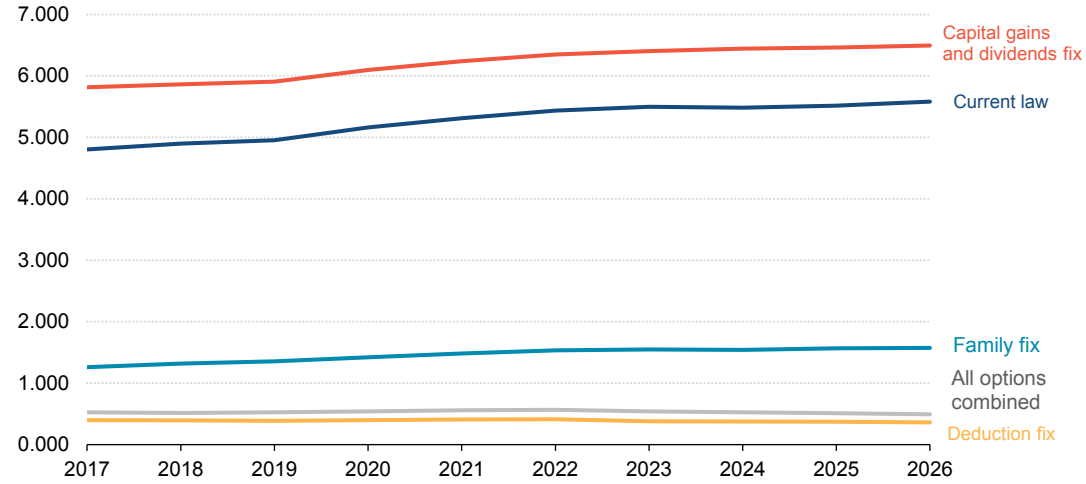
Impact of Reform Options on Tax Revenue
FY2017-26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: Baseline is current law. Proposals are effective 01/01/2016. Estimates include a microdynamic behavioral response. Estimates assume a 40-60 fiscal split, i.e. fiscal year revenue is estimated to be 60 percent of revenue from the previous calendar year plus 40 percent of revenue from the current calendar year.

FIGURE 2

Impact of Reform Options on Number of AMT Payers
2017-26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Note: AMT payers include those with direct AMT liability on Form 6251, lost credits, and reduced deductions.

How Could We Improve the Federal Tax System?

How might we improve the AMT?

Overhaul

An alternative to this sort of incremental reform would be to combine the AMT's repeal with a major reform of the individual income tax that would prevent the sheltering behavior that the minimum tax was originally designed to prevent. Stand-alone repeal of the AMT would cost $388.9 billion over the next 10 years.

Data Source

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Q. What policy reforms could simplify the tax code?

A. Reducing the number of distinctions among economic activities and taxpayers' personal characteristics would simplify the code, reducing both compliance costs for taxpayers and administrative costs for the government. The consequent broadening of the tax base would allow lower tax rates while maintaining revenue and also reduce economic distortions caused by taxation.

The key to tax simplification is to make fewer distinctions across economic activities and taxpayers' personal characteristics. This would not only reduce compliance costs, but allow for simpler administration. For example, if everyone paid the same tax rate on dividends, the tax could be collected from dividend payers without having to trace who got what.

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 do now), a basic exemption amount, and the choice of tax base (income, consumption, or another measure), rather than through specific provisions that treat different levels of income and consumption differently. Universal exemptions, deductions, or credits are much simpler to administer than targeted ones.

Several fairly modest changes could make the current tax system simpler as well as fairer and more conducive to economic growth. One possible focus: the individual alternative minimum tax (AMT). To spare middle-income taxpayers who were never its target, the AMT should allow deductions for dependents and for state and local taxes. Further, all personal credits should be available against the AMT. Any new proposal that cuts regular income tax liabilities should also make conforming adjustments to the AMT so that more taxpayers are not subjected to it.

Another option would coordinate the phaseout of tax credits. Specific tax credits phase out across different income ranges, so that claiming each credit requires a separate worksheet and tax calculation. The phaseouts also create hidden taxes over the phaseout range and diminish the effectiveness of the credits by encouraging the very activities they are designed to spur.

How Could We Improve the Federal Tax System?

What policy reforms could simplify the tax code?

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Q. How might the taxation of capital gains be improved?

A. Taxing capital gains at the same rates as ordinary income would simplify the tax system by removing major incentives for tax sheltering and other attempts to manipulate the system.

The Tax Reform Act of 1986, signed by President Ronald Reagan, raised tax rates on capital gains and lowered rates on ordinary income, but set the same 28 percent top rate for both. The goal: reducing tax planning devoted to converting ordinary income to capital gains. The policy worked—briefly. Successive congresses raised the top rate on ordinary income (now 43.4 percent) and reduced the top rate on capital gains (now 23.8 percent). As the gap between the two rates widened, so did the incentives to manipulate the system. Now might be a good time to once again tax capital gains and ordinary income at the same rate, which would be higher than today's rate on capital gains but lower than the rate on ordinary income.

In the 1980s, taxpayers exploited the ordinary income/capital gain gap by making investments that generated ordinary deductions—such as interest, lease payments and depreciation—to reduce their current income tax liability. These taxpayers got their money back (and presumably more) in the form of long-term capital gains. The '86 act targeted these arrangements by limiting the use of passive loss, interest, and accelerated depreciation deductions. But, most importantly, the '86 act also eliminated the ordinary income/capital gain gap, which removed much of the juice.

With the return of the ordinary income/capital gap, various schemes to convert ordinary income into capital gains have followed. Last year, the Senate investigated basket options, which used the tax alchemy of derivatives to convert short-term into long-term capital gains. Over the last several years, private equity and other investment managers have been compensated with "carried interest," which allow them to claim long-term gains rather than salaries.

These planning opportunities are available only to the well off. More generally, capital assets are held predominantly by the well-off, who derive the most benefit from the capital gains preferences (figure 1).

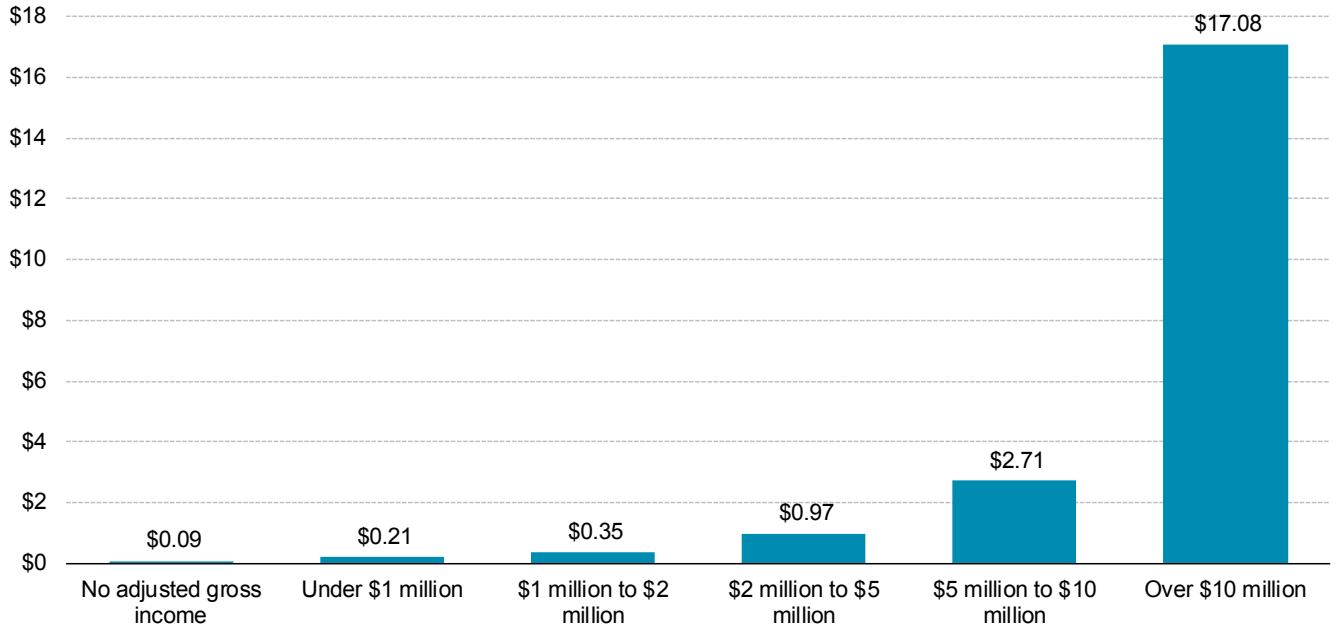
How Could We Improve the Federal Tax System?

How might the taxation of capital gains be improved?

FIGURE 1

Average Taxable Net Capital Gain by Adjusted Gross Income
2014

Millions of dollars



Source: IRS SOI, Table 1.4

Some may object that reducing the tax rate on capital gains is necessary to prevent "lock in"—holding property to defer tax liability (perhaps until death, when the tax basis of the asset is stepped up to permit heirs to sell without realizing any taxable gains). But if Congress is concerned about the lock-in effect, it could either tax capital gains at death or reinstate the carryover basis so that heirs retain the lower basis. Either step would reduce the tax incentive to keep assets until death—and could raise substantial revenue that would make it possible to reduce tax rates or the deficit.

Finally, if Congress is concerned about the potential double taxation of corporate earnings, it might integrate the two levels of taxes on corporate income. That is, Congress could tax corporate earnings only once, taxing the corporation or its shareholders but not both. The US Treasury (1992) has laid out several options for such integration.

How might the taxation of capital gains be improved?

Data Source

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Q. How could we reform the estate tax?

A. Possible reforms run the gamut from repeal to modest fixes that would make the tax more difficult to avoid.

Proposals to reform the estate and gift tax range from comprehensive options, such as permanently repealing the estate tax or replacing the existing tax with a tax on inheritances, to more modest options, such as decreasing exemption amounts, increasing tax rates, and blocking avenues for avoiding the tax.

The federal estate and gift taxes (including the generation-skipping tax, or GST) have changed virtually every year since 2001. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut these taxes sharply but only through 2010. EGTRRA gradually phased out the estate tax and GST, and eliminated them 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 reinstated the estate tax and GST for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent. But it allowed executors to elect the EGTRRA rules for decedents who died in 2010. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012 (ATRA), though with a new top rate of 40 percent. In light of numerous recent proposals to repeal these taxes or reform them in some manner, how "permanent" the ATRA changes are remains to be seen.

Many members of Congress have called for the repeal of the estate and gift taxes. That would be expensive, however. The Congressional Budget Office projects that these taxes will raise $250 billion in fiscal years 2017 through 2026.

Repeal would also be regressive—the benefits would go almost entirely to people at the top of the income distribution—and would invite significant sheltering of income. Further, 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. Prior estimates indicate that repealing the estate tax would reduce charitable donations by 6 to 12 percent.

One option, the substitution of an inheritance tax, would tax wealth transfers somewhat differently. 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. Most countries that tax wealth transfers do so with inheritance taxes rather than estate taxes.

How Could We Improve the Federal Tax System?

How could we reform the estate tax?

A more modest reform could address the loopholes, such as special trust arrangements and valuation discounts. Those tax avoidance measures complicate estate planning and result in unequal taxes on comparable estates. Closing loopholes could increase revenues, moreover, allowing a higher estate tax exemption, lower rates, or deficit reduction.

The following reforms would only change the estate tax exemption level and rates, and the treatment of wealth transfer taxes paid to states (figure 1).

- **Pre-ATRA Law:** The old law had an exemption level of $1 million (not indexed for inflation) and a top statutory rate of 55 percent, along with a 5 percent surtax that phased out the benefit of lower rates for large estates and a credit (rather than a deduction) for state wealth transfer taxes. Making pre-ATRA law permanent starting in 2017 would increase the number of estate tax returns filed between 2017 and 2026 by 1.5 million and increase the estate tax liabilities of these decedents by $405 billion.

- **2012 Law:** The estate tax law in effect in 2012 had an exemption of $5 million (indexed for inflation from 2011) and a top rate of 35 percent, so it differs from current law only in the top rate. Making 2012 law permanent starting in 2017 would not affect the number of estate tax returns filed but would decrease estate tax liabilities by about $29 billion for decedents who died between 2017 and 2026.

- **2009 Law:** The estate tax law in effect under EGTRRA for 2009 had an exemption of $3.5 million and a top rate of 45 percent. If 2009 law were made permanent starting in 2017, the number of estate tax returns filed between 2017 and 2026 would increase by 142,000, and estate tax liabilities of these decedents would increase by $131 billion.

- **2009 Law, Exemption-Indexed:** If 2009 law, modified to index the exemption to inflation, were made permanent starting in 2017, the number of estate tax returns filed between 2017 and 2026 would increase by 81,000, and estate tax liabilities of these decedents would increase by $88 billion (about one-third less than the increase without indexing the exemption).

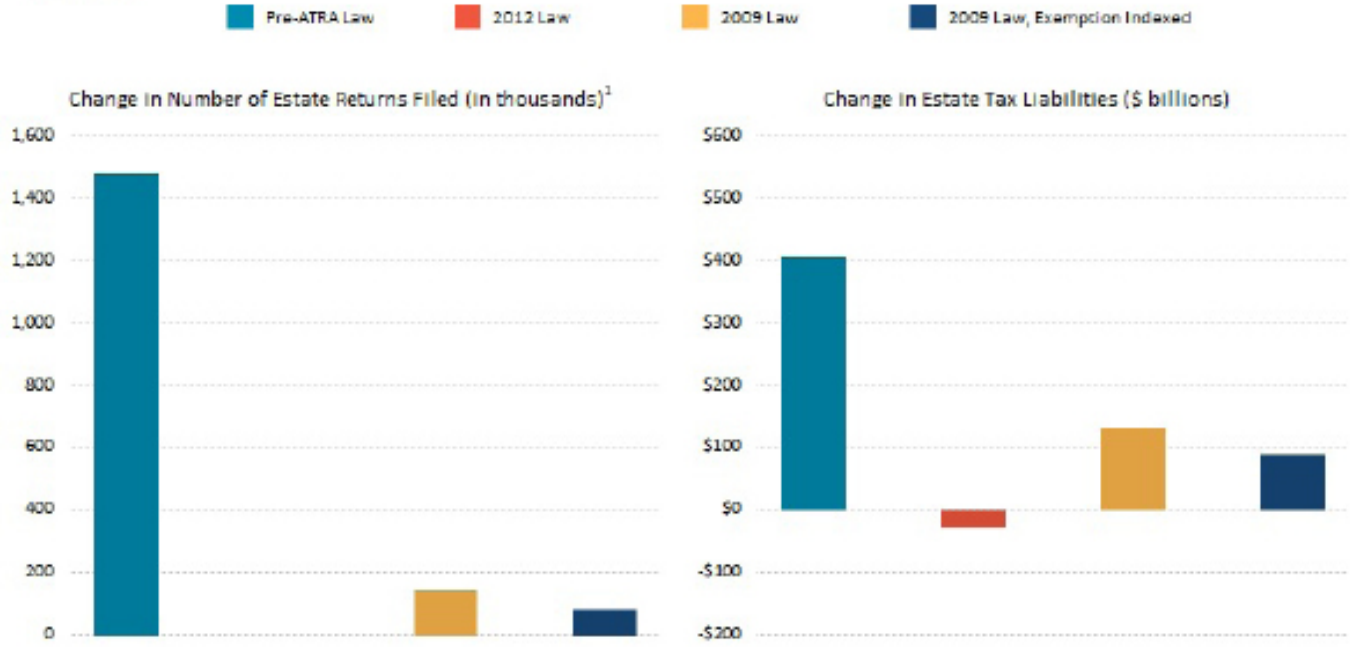
How Could We Improve the Federal Tax System?

How could we reform the estate tax?

FIGURE 1

Change in Total Number of Estate Tax Returns Filed and Estate Tax Liability Under Alternative Reforms

2017-2026



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
(1) There is no change in the number of returns filed under 2012 law because the exemption is the same as under current law.

Data Source

Urban-Brookings Tax Policy Center. Microsimulation Model, version 0516-1.

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Q. How can we improve incentives for charitable giving?

A. Proposals include establishing a floor on deductions in exchange for more effective incentives such as offering a nonitemizer charitable deduction, strengthening the IRA charitable rollover, revising the excise tax on foundations, raising the limit on deductions, and allowing people to claim charitable deductions for the previous year up to the time of filing tax returns, as in the case of deposits to individual retirement accounts.

Under current law, taxpayers who itemize are allowed to deduct most of their charitable contributions, thereby reducing their tax liability. Taxpayers who do not itemize 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. Some of these proposals would replace less effective incentives with more effective ones.

FLOOR ON DEDUCTIONS

One proposal would expand the existing incentive in exchange for a floor on deductions. This makes sense because incentives are more powerful for the incremental dollar of giving than for the first dollar.

Consider a person who would give away $1,000 with no tax 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 would have a greater effect than one for the first $100 or even the first $1,000, which would 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 then be used to expand other incentives. For instance, nonitemizers who give significant amounts to charity might be allowed to deduct some of their charitable contributions.

The revenue gains from a floor could be significant. The Congressional Budget Office estimated that only allowing deductions that exceed 2 percent of adjusted gross income (AGI) would increase federal revenue by more than $15 billion a year. A more modest floor would still provide substantial revenues that could be used to increase other, more powerful, incentives to give.

How Could We Improve the Federal Tax System?

How could we improve incentives for charitable giving?

NONITEMIZER DEDUCTIONS

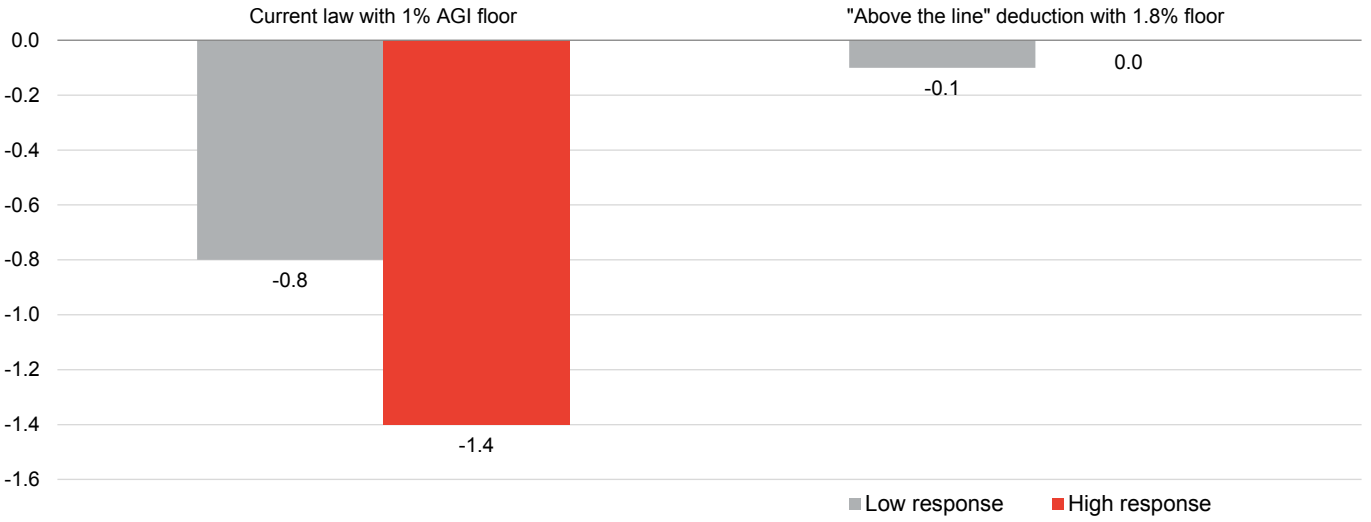
At present, taxpayers who take the standard deduction cannot claim a deduction for charitable giving. Extending the deduction to these nonitemizers would likely increase charitable contributions, but by itself might create compliance problems: the Internal Revenue Service cannot reasonably be expected to audit small donations. Also, offering a deduction to nonitemizers separate from the deduction for itemizers 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 1.8 percent of AGI, regardless of whether they itemize. This combination would likely have little impact on charitable giving but would raise as much as $10 billion in tax revenue, and would address concerns about administration and compliance. How much net giving would change depends upon the sensitivity of giving to incentives (figure 1).

FIGURE 1

Impact on Charitable Giving of Options to Change the Charitable Deduction

2011



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

RAISING THE LIMIT ON THE DEDUCTION

Another option would be to raise the limit on deductions above the current 50 percent of AGI. This would significantly increase incentives at the margin for large givers. One could also make the carryover provisions more generous with respect to the 50 percent limit. 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.

How Could We Improve the Federal Tax System?

How could we improve incentives for charitable giving?

IRA ROLLOVERS

Yet another proposal would expand the charitable individual retirement account (IRA) rollover provision. This provision allows some taxpayers over age 70 years and 6 months to donate up to $100,000 from traditional IRAs to charity without having to count the distributions as taxable income or separately take an itemizer deduction for already excluded income. Raising or eliminating the $100,000 annual limit on donations, lowering the age limit to 59 years and 6 months (the age at which IRA owners may withdraw funds without penalty), or allowing such giving to be deposited in donor advised funds (currently ineligible for such tax treatment) could increase charitable giving.

FOUNDATION EXCISE TAX

Another option would eliminate or reform the excise tax on foundation income. The current excise tax on income from foundation assets was initially intended to cover the IRS's costs of overseeing the tax compliance of charitable organizations, but the monies were not appropriated. The tax rate is either 1 or 2 percent, depending on whether the year's giving equals or exceeds the average of the last few years. Under these current rules, foundations that give at above-average rates 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 very least, Congress could impose a single tax rate on all such income; this would eliminate the current perverse incentive for foundations to limit current grants today in order to avoid a higher tax in the future.

ALLOWING CHARITABLE DEDUCTIONS UP TO APRIL 15 OR TIME OF FILING TAX RETURNS

Another proposal that passed the House of Representatives, sometimes called the April 15 option, would allow individuals to take charitable deductions up to April 15 or the time of filing tax returns. The proposal costs the government almost nothing if there are no increases in giving because it doesn't really change the subsidy value of gifts already made. In terms of bang per buck, or increased giving per dollar of revenue cost, it ranks very high, since the incentive for the most part only loses revenues when there are additional gifts. Economic and marketing evidence supports the notion that people would give more because they would be more aware of the size of the incentive; meanwhile, tax return preparers and tax software developers would help advertise the opportunity at hand, and people would receive immediate rather than delayed support for their contributions.

How Could We Improve the Federal Tax System?

How could we improve incentives for charitable giving?

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Q. What are the options for international tax reform?

A. On its face, reforms that would remove the incentive for US corporations to move abroad and lower corporate tax rates to make US corporate activity more competitive seem straightforward. In fact, unraveling the Gordian knot created by taxation-as-usual would be far from simple.

FLAWS OF CURRENT US INTERNATIONAL TAX RULES

There's seemingly no end to complaints about the impact of the US corporate tax in the context of an increasingly integrated global economy. Among them are the following:

- Deferral of foreign-source income until it is repatriated encourages multinationals to locate business activity and to report profits in low-tax countries.
- The taxation of foreign-source income of US-based firms when repatriated, along with the controlled foreign corporation (CFC) rules that tax some foreign-source income as it is accrued, place US-resident multinationals at a competitive disadvantage with firms resident in countries that exempt most foreign-source income and have weaker CFC rules.
- The timing of tax liability when income is repatriated, combined with rules that allow US firms to report their accumulated foreign profits as permanently invested overseas, have in recent years encouraged US resident multinationals to accumulate substantial assets abroad, some of which could be more effectively deployed if invested in the United States or paid as dividends to shareholders.
- The complexity of the various rules apportioning income by jurisdiction and preventing tax avoidance by limiting deferral and the use of offsetting foreign tax credits raise compliance costs. Yet they still offer substantial opportunities for legal tax avoidance.
- Taxes on foreign-source income of US multinationals raise relatively little revenue, even though the US corporate tax rate exceeds the tax rate in other countries in which US firms report profits.

REFORM OPTION: ELIMINATE DEFERRAL

Eliminating the deferral of US tax liability on the non-repatriated foreign-source income of US-based multinationals would increase revenue and substantially reduce firms' incentives to earn income in (or to shift profits to) low-tax countries. However, eliminating deferral could put US-based multinationals at an additional competitive disadvantage by raising the tax rate they pay on income earned in low-tax countries compared with taxes paid by foreign-based multinationals. And that, in turn, would create greater incentives for US firms to change their tax residence through mergers with foreign-based firms.

How Could We Improve the Federal Tax System?

What are the options for reforming international taxation?

Congress could enact additional rules to discourage these "inversion" transactions. But they could not foreclose every option that allows US firms to shift corporate activity to foreign-resident multinationals.

Competitiveness concerns could be allayed, but only in part, by combining the elimination of deferral with a large (but still revenue-neutral) reduction in the US corporate income tax rate. Indeed, that is the centerpiece of tax reform plans introduced by Senate Finance Committee ranking Democrat Ron Wyden along with current and former Republican senators Dan Coats and Judd Gregg. It would have eliminated deferral while substantially reducing the top corporate tax rate.

REFORM OPTION: TERRITORIAL SYSTEM

A territorial system would exempt the foreign income of US multinational firms from US taxation. Such a system would likely enhance the competitiveness of US-based multinationals compared with foreign-based firms and reduce (but not entirely eliminate) the incentive for inversions.

The most important argument against a territorial system is that by exempting foreign income, it would reinforce the already strong tax incentive to locate economic activity and to report profits in low-tax countries. Such tax-motivated changes in behavior are generally economically inefficient and could further erode the US corporate income tax base.

That's a fair point: Depending on its design, a territorial system could bring in less tax revenue than the existing system. Harry Grubert and John Mutti (2007) have suggested, however, that revenue could actually increase under a territorial system if royalty income from abroad were defined as domestic-source income and interest allocation rules were changed.

A territorial system could simplify taxation of international income because exempting foreign income from taxation would reduce the sort of tax planning now needed to optimize the use of foreign tax credits to shield repatriated foreign income from US taxes. However, under the new system, firms would still have to distinguish between foreign and domestic income, identify passive income that is subject to CFC rules, and appropriately allocate expenses to their operations in different countries. In addition, the stronger incentives to shift income produced by eliminating the repatriation tax would further strain the rules in place to prevent bogus profit shifting through inappropriate transfer pricing.

REFORM OPTION: IMPROVED HYBRID SYSTEM

President Obama and congressional leaders from both parties have proposed variants of a "hybrid" system that would continue to impose a lower effective tax rate on foreign-source income than domestic-source income of US multinationals but eliminate the tax on repatriated profits. These proposals, while different, have three main elements in common:

- They would eliminate taxation of repatriated foreign-source profits of US multinational corporations.
- They would impose a one-time transition tax on currently accrued overseas profits of US multinationals, to be collected over several years.
- Going forward, they would impose a low rate tax on accrued foreign-source "intangible" profits of US multinationals in order to discourage the sort of income-shifting to low-tax countries that a pure territorial system would encourage.

On the plus side, the hybrid proposals would remove the incentive for US corporations to accrue assets overseas by eliminating taxation upon repatriation. But they would not resolve the tension between reducing the incentive for US companies to invest and report income overseas and improving the competitiveness of US-based multinationals. Depending on design details, a proposal in this form could either raise or lower the effective tax rate on foreign-source income.

REFORM OPTION: DESTINATION-BASED TAXES

A more fundamental reform option would replace the current corporate income tax with a destination-based tax. A destination-based tax is based on where a corporation's products are purchased rather than where they are produced, where the corporation is located, or where the corporation records its income. The major benefits of a destination-based tax from an international point of view is that it would eliminate incentives under the U.S. corporate income tax for firms to invest and report income overseas instead of at home and eliminate incentives for U.S. firms to "re-domicile" themselves as foreign-based firms.

Some examples of destination based taxes are a value added tax (VAT) or a business cash-flow tax. Under a VAT, border adjustments would impose the tax on imports but exempt exports by rebating any VAT previously collected at earlier stages of production. Under a destination-based business cash-flow tax border adjustments would exempt export sales from tax and not allow firms to deduct the cost of imports. The destination-based cash flow tax, however, raises its own issues, including whether the border adjustments would be acceptable to the World Trade Organization and whether it would be politically feasible to pay large rebates to export firms who would experience tax losses under the plan and impose large new taxes on importers.

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How Could We Improve the Federal Tax System?

Q. What is comprehensive tax reform?

A. The term refers to broad, sweeping changes to the tax system. What qualifies as "comprehensive" is a judgment call.

Rather than taking a piecemeal approach, making small changes to provisions of the tax code, comprehensive reform would address the inequities, complexities, and inefficiencies of the entire tax system. The last comprehensive reform to the US tax system took place in 1986, when the Tax Reform Act lowered income tax rates and broadened the tax base.

Some contemporary proposals are really more of the same, lowering tax rates without losing revenue by broadening the base. Some proposals would scrap the current system entirely, replacing the income tax with a consumption-based tax system. But the broad goals of greater fairness, efficiency, and simplicity remain the same.

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Q. What are the major options for comprehensive tax reform?

A. In a nutshell, broaden the income base while lowering tax rates, tax consumption instead of income, or do a bit of both.

INCOME TAX BASE-BROADENING

Base-broadening involves increasing the portion of income subject to taxation. It is often accompanied by proposals to decrease tax rates. The Bowles-Simpson plan, the Tax Reform Act of 2014, and a proposal from the Domenici-Rivlin Debt Reduction Task Force all fit this category.

In calculating tax liability, taxpayers have the right to exclude portions of their income through deductions, credits, exclusions, and the preferential treatment of income from favored sources. This, of course, lowers the revenues that could be collected if all income were taxed at the given rate. There are more than 150 such "expenditures" in the tax code; the 10 largest account for approximately two-thirds of the budget impact and currently cost the government about $900 billion per year.

SWITCHING TO A CONSUMPTION TAX

A consumption levy taxes the purchase of goods or services rather than income. A move to such a system was proposed by the 2005 Panel on Tax Reform and forms the basis of Columbia University Law professor Michael Graetz's "Competitive Tax Plan" and several other plans usually labelled as national retail sales taxes and flat taxes.

Retail Sales Tax

A national retail sales tax would levy a flat tax on all retail sales. In most proposals, the tax would have a broad base, exempting only expenditures for education, existing housing, purchases abroad by US residents, and food produced and consumed on farms. Proponents argue that the tax would be simpler to administer and create fewer economic distortions than the income tax. However, in most forms it would be regressive, disproportionately taxing low- and middle-income earners.

How Could We Improve the Federal Tax System?

What are the major options for comprehensive tax reform?

Value-Added Tax

Value-added taxes are collected from businesses at each stage of the production process. Under the "credit-invoice method," all sales by businesses are taxable, while firms claim credits for all taxes paid on purchases from other businesses. The result is that the tax base is equal to the full value of the final sale to the end user. The United States is the only developed country that does not have a value-added tax, which tend to have lower administrative and compliance costs than income taxes.

Flat Tax

A flat tax is really a value-added tax divided into two parts. It was first proposed in 1983 by economists Robert Hall and Alvin Rabushka of Stanford University's Hoover Institution. Their proposal called for a 19 percent tax at the business level on all value added other than wages. Households, for their part, would pay a 19 percent flat tax on all wages and pension benefits above a specified exemption level. The family exemption increases the progressivity of the tax. But the tax structure is regressive relative to the current system as it lowers taxes for households at the high end of income distribution.

X-Tax

The X-tax, proposed by the late David Bradford, is a variant of the flat tax. Businesses would still pay a single-rate value-added tax on all of their nonwage value added. But unlike the flat tax, the wage tax would be set at progressive rates, beginning at a zero rate and increasing until the business rate is reached. The plan would retain the earned income tax credit and the deduction for charitable contributions and would provide a credit for payroll taxes paid. A modified version of the X-tax was proposed in the 2005 reports of the President's Advisory Panel on Tax Reform, in which the income tax would be replaced with a 30 percent tax on firms and top wage earners. (The panel would have supplemented the X-tax with a 15 percent tax on capital income earned by individuals.)

Consumed Income Tax

In general, all income can either be spent immediately or saved to be spent later. A consumed income tax would tax only current consumption, exempting all savings until it is spent. Proponents argue that the exemption of savings would encourage investment, which would increase economic growth. A variation of the consumed income tax, the Unlimited Savings Allowance Tax, was offered by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM) in 1995 as a replacement for the income tax. Under their plan, households would be taxed with a progressive consumed-income tax. They would be able to deduct some education costs, mortgage interest, and charitable contributions. Businesses, for their part, would be taxed with a subtraction-method value-added tax with a flat rate of approximately 11 percent. Both households and businesses would be able to claim a payroll tax credit.

How Could We Improve the Federal Tax System?

What are the major options for comprehensive tax reform?

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Q. What is a broad-based income tax?

A. One that minimizes tax preferences with the goal of increasing revenue for a given rate of taxation.

Expanding the definition of taxable income by removing or restructuring tax preferences could significantly increase revenue. In fact, the President's Advisory Panel on Tax Reform estimated that converting the current preference-riddled tax to a comprehensive income tax system would nearly double the tax base.

In truth, virtually all tax analysts reach similar conclusions. Holding other factors constant, a broader tax base means that a lower tax rate is required to raise the same revenue. Hence, base broadening can be used to offset the revenue effects of lowering the tax rate.

The National Commission on Fiscal Responsibility and Reform (Bowles-Simpson, for short) aimed to broaden the tax base by eliminating up to $1.1 trillion worth of tax expenditures, with the revenue gains used to reduce both tax rates and the budget deficit. The Domenici-Rivlin tax reform proposal also features base broadening as a deficit reduction tool and would accomplish the task with a mix of eliminating, reducing, and simplifying various tax expenditures.

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Q. What would and would not be taxed under a broad-based income tax?

A. There are as many options as there are proposals.

Base broadening could include all forms of income, such as wages and "anything that allows you to spend more, either now or in the future" (President's Advisory Panel 2005). These sources include retirement account income, capital gains, dividends, rental income, employer-provided health insurance, unrealized increases in the value of real estate, and securities.

The President's Advisory Panel looked closely at a somewhat less comprehensive broad-based income tax that would eliminate credits, "above the line" deductions, and itemized deductions. The individual alternative minimum tax would go; tax filers would get to keep the standard deduction and personal exemptions.

The Bowles-Simpson Commission's "zero-base budgeting" plan would modify the income tax to lower rates and deficits by cutting tax expenditures. This tax would eliminate all tax expenditures (an estimated $1.1 trillion per year) but would not modify the payroll tax base.

The Domenici-Rivlin plan, for its part, eliminates the standard deduction and personal exemption, taxes capital gains and dividends as ordinary income, simplifies the earned income tax credit, shortens the list of itemized deductions, and caps deductions for medical expenses.

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Q. What would the tax rate be under a broad-based income tax?

A. That depends on what exclusions, credits, and deductions are left in and whether revenue neutrality is a must.

The President's Advisory Panel on Tax Reform estimated how much marginal tax rates could be reduced under a broad-based tax that generated the same revenue as the current system. As table 1 shows, the switch would permit across-the-board cuts of about one-third. This sort of reform would not be an easy political pill to swallow, however. The panel's version, for example, would preserve only the standard deduction and personal exemptions, and would eliminate credits, "above-the-line" deductions, and itemized deductions. On the plus side, it would eliminate the much-despised individual alternative minimum tax.

TABLE 1

Marginal Tax Rates for Married, Filing Jointly Households

Under current law and a broad based system, 2006

Tax bracket	Current law system	Broad based system
$15,050 and under	10.0%	6.6%
$15,050 – $61,100	15.0%	9.9%
$61,100 – $123,250	25.0%	16.4%
$123,250 – $187,800	28.0%	18.4%
$187,800 – $335,400	33.0%	21.7%
$335,400 and over	35.0%	23.0%

Source: President's Advisory Panel (2005).

The Bowles-Simpson alternative provides similar estimates, but argues that its zero-base budgeting methodology allows for simultaneous reduction of rates and the deficit (table 2).

How Could We Improve the Federal Tax System?

What would the tax rate be under a broad-based income tax?

TABLE 2

Marginal Tax Rates in 2011 Under Current Law and Broad Based Systems

Bowles-Simpson

Tax rate bracket	Current law system	Broad based system	Illustrative plan[a]
Bottom rate	15.0%	8.0%	12.0%
Middle rate	28.0 – 31.0%	14.0%	22.0%
Top rate	36.0 – 39.6%	23.0%	28.0%

Source: National Commission (2010).

(a) The Illustrative Plan eliminates all tax expenditures except for the Child Tax Credit and Earned Income Tax Credit. It also taxes capital gains and dividends as ordinary income.

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Q. What is a national retail sales tax?

A. A national retail sales tax is a consumption tax that is collected as a flat-rate tax on all sales from businesses to households.

Retail sales are business sales to households; neither business-to-business nor household-to-household transactions qualify. 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 home to a business that intends to rent it to others is not a retail sale, nor is the sale of an existing home by one occupant to another.

A pure national retail sales tax would represent a sharp break from the current tax system, shifting the tax base from income to consumption. Rates would be flat; there would be no exempted or favored goods or services; and 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 rate anywhere near as high as what would be required to replace the US tax system. Whether such a tax could be implemented effectively remains an open question.

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Q. What would and would not be taxed under a national retail sales tax?

A. In theory, everything would be taxed. In practice, there would be great pressure to narrow the base.

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 would not be subject to tax.) However, no sales tax in history has come close to this ideal. Some items, such as imputed financial services, are quite difficult to tax. Taxing others, such as child care, rent, food, housing, and health care, might undermine popular (and arguably desirable) social policies.

The experience of the states demonstrates that interest groups often succeed in carving out preferences, just as they do from the income tax. As a result, few existing state sales levies tax many of the items listed above, and none tax all of them. Hence, there is no precedent for a pure broad-based national retail sales tax.

However, the path of least political resistance—exempting selected sectors—would be problematic. The broader the tax base, the lower the tax rate can be and still reach the revenue target. But health, food, and housing make up more than 40 percent of all personal consumption; exempting even one of these sectors would cut deeply into the sales tax base, forcing the required rate higher. Moreover, even with a very broad base, the required tax rate would have to be very high to replace existing federal taxes.

Consider, too, that a national retail sales tax would need to tax all purchases by state and local governments. Exempting them would narrow the base substantially, which in turn would raise the tax rate needed to generate 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.

Although the details of various national retail sales tax proposals vary, they generally maintain similar tax-base characteristics. Exemptions would be provided for business purchases and education, both of which are considered investments. Domestic purchases by foreigners would be taxed; foreign purchases by US residents would not.

Employer-provided health insurance would be taxed, but economists Jonathan Gruber and James Poterba estimate that this tax change would boost the price of health insurance by an average of 21 percent. This price increase would reduce both the number of people insured (by 6 million to 14 million) and the amount of insurance that each remaining insured person would choose to carry.

How Could We Improve the Federal Tax System?

What would and would not be taxed under a national retail sales tax?

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 existing houses would generally not since such transactions would not constitute retail (business-to-household) sales. This change would lower the market value of new houses relative to old ones.

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How Could We Improve the Federal Tax System?

What would the tax rate be under a national retail sales tax?

Q. What would the tax rate be under a national retail sales tax?

A. It depends on assumptions about the breadth of the tax base, tax evasion and avoidance, and the effects on economic growth. It also depends on how the tax rate is measured. Estimates for a tax that would replace revenues from the current federal tax system range from 31 percent to 65 percent.

Perhaps the most controversial aspect of the national retail sales tax has been how high the tax rate would need to be to replace all revenue from the current tax system. The answer depends on four things: whether the quoted rate is in tax-exclusive or tax-inclusive terms; 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.

TABLE 1
Range of Average Tax Rates Under a Retail Sales Tax[a]
2006–15

Avoidance, evasion, and legislative erosion rate	Tax-exclusive rate	Tax-inclusive rate
None	44%	31%
10%	53%	34%
20%	65%	39%

Source: Gale, 2005.
(a) Estimates assume a baseline of current law revenue projections.

Estimates from the President's Advisory Panel on Tax Reform span an even wider range. Using reasonable assumptions about tax evasion and the breadth of the tax base, the Advisory Panel estimated the required tax-exclusive tax rate to be between 34 and 89 percent. Their highest estimate assumes an evasion rate consistent with rates in the current income tax for income on which taxes are not withheld and there is no third-party reporting, and a federal tax base equivalent to the median state sales tax base.

How Could We Improve the Federal Tax System?

What would the tax rate be under a national retail sales tax?

TABLE 2

Range of Tax Rates Under a Retail Sales Tax[a]

Evasion rate	Extended base[b]	Median state sales tax base
Lower evasion (15%)	34%	64%
Higher evasion (30%)	49%	89%

Source: President's Advisory Panel on Tax Reform, 2005.
(a) Tax exclusive rates.
(b) 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.

TAX EXCLUSIVE OR TAX INCLUSIVE

A key issue in determining the required tax rate is how to define the tax rate. Suppose a product 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 rate rises. 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.

OTHER FACTORS WOULD RAISE THE RATE EVEN HIGHER

The total sales tax rate that households would face would 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 income and other information. Today's state income taxes would likely be converted to sales taxes, adding considerably to the combined sales tax rate.

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.

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Q. What is the difference between a tax-exclusive and tax-inclusive sales tax rate?

A. It depends on whether the tax is reported relative to the pretax or post-tax price.

Suppose a widget costs $100 before tax and is subject to a $30 sales tax. The tax-exclusive tax rate would be 30 percent, since the tax is 30 percent of the pretax 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). 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 increases 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, which is a big difference.

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.

Further Reading

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Q. Who bears the burden of a national retail sales tax?

A. A revenue-neutral national retail sales tax would be more regressive than the income tax it replaces.

A national retail sales tax would create a wedge between the prices paid by final consumers and amount received by sellers. Theory and evidence suggests that the tax would be passed along to consumers via higher prices.

Because lower-income households spend a greater share of their income than higher-income households do, the burden of a retail sales is regressive when measured as a share of current income: the tax burden as a share of income is highest for low-income households and falls sharply as household income rises. The burden of a sales tax is more proportional to income when measured as a share of income over a lifetime. Even by a lifetime income measure, however, the burden of a sales tax as a share of income is lower for high-income households than for other households because a sales tax (like any consumption tax) does not tax the returns (such as dividends and capital gains) from new capital investment and income from capital makes up a larger portion of the total income of high-income households.

In contrast, federal income taxes are progressive. The individual income tax is progressive, thanks to the impact of refundable credits for lower-income households (average tax rates are negative for the two lowest income quintiles), the standard deduction and personal exemptions (which exempt a minimum level of income from the tax), and a graduated rate structure (rates on ordinary income rise from 10.0 to 39.6 percent, with an additional 3.8 percent marginal tax on certain investment income of high-income households).

The President's Advisory Panel (2005) concluded that replacing the income tax system with a national retail sales tax would heavily favor high-income households. A sales tax rate of 22 percent (the rate necessary to replace the revenue from the federal income tax) would increase tax burdens on the lower 80 percent of the income distribution by approximately $250 billion a year (in 2006 dollars), if the sales tax was not modified to return some revenue to lower-income households.

Put another way, the lower 80 percent of the income distribution would go from paying 15.8 percent of federal income taxes to paying 34.9 percent of federal retail sales taxes. Conversely, the top 20 percent of the income distribution would go from paying 84.2 percent of federal income taxes to 65.1 percent of federal retail sales taxes.

The Advisory Panel also found that offsetting the regressivity of the tax change by per capita rebates to disadvantaged households would require a 34 percent sales tax rate to sustain current levels of tax revenue.

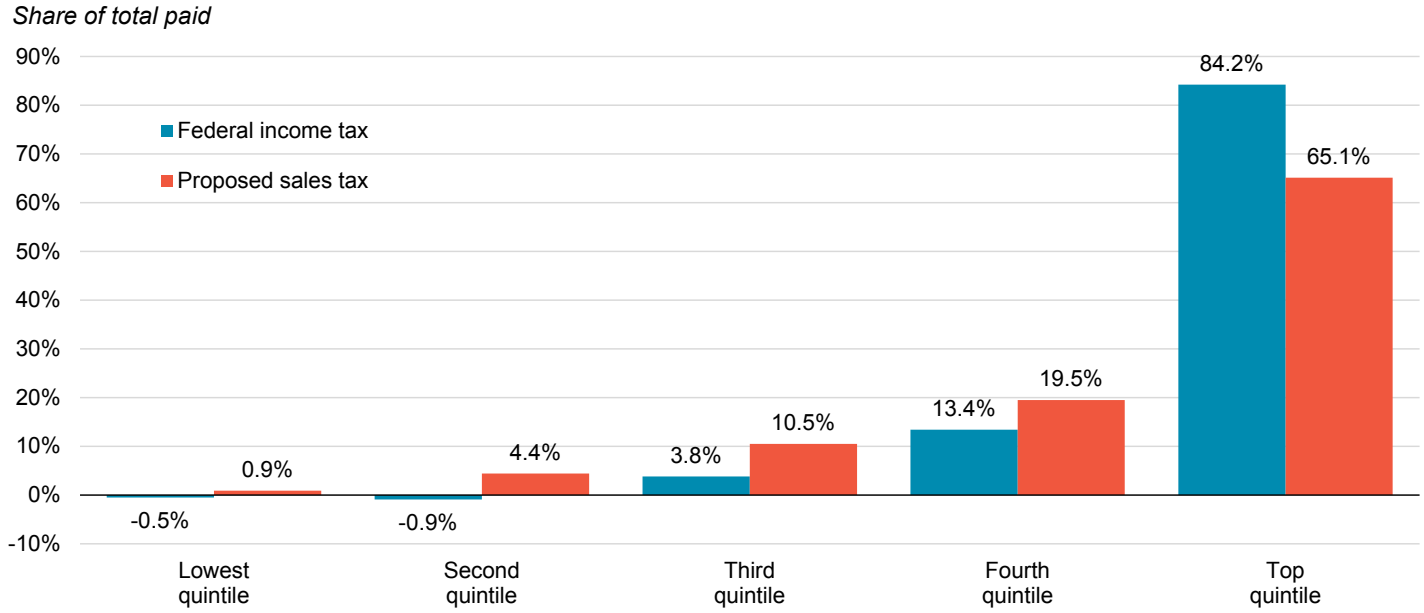
How Could We Improve the Federal Tax System?

Who bears the burden of a national retail sales tax?

FIGURE 1

Share of Current Federal Income Tax or Proposed Retail Sales Tax Paid[a]

By income level under 2006 law



Source: President's Advisory Panel on Tax Reform (2005).
(a) Assumes a 22% National Retail Sales Tax without demogrant.

Some claim that a properly modified national retail sales tax would be "pro-family." Advocates usually point to the proposed "demogrant"—the per capita cash rebates—as proof of this assertion. On the other side of the ledger, though, 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 EITC, child care credits, education credits, and child tax credits). Consider, too, that at any given income level, families with children have higher consumption requirements than those without, so switching to a consumption tax would present an inherent disadvantage for families with kids.

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Q. Would tax evasion and avoidance be a significant problem for a national retail sales tax?

A. A national retail sales tax would certainly not eliminate tax evasion and avoidance, and might increase it.

Advocates of the national retail sales tax claim that tax avoidance and outright evasion would decline, and that tax revenue collected from the underground economy would rise significantly. But critics view these claims as somewhere between overoptimistic and nonsensical. The President's Advisory Council on Tax Reform (2005) 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."

By eliminating the current tax system, the national retail sales tax would indeed eliminate current avoidance and evasion schemes. But that does not mean it would eliminate avoidance and evasion. It would simply change their locus and nature.

The overall rate of evasion of the US income tax is estimated at around 15 percent. But this figure masks great differences in evasion that depend on the source of the income. At one extreme, where taxes are withheld and reported to government by a third party (predominantly wages), the evasion rate is just 5 percent. At the other, where taxes are not withheld and there is no cross-reporting among government agencies, 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 potential for evasion needs to be taken seriously.

Individuals might avoid or evade a national retail sales tax in several ways. They might misreport personal consumption as business activity (e.g., using a company car for personal use). Treating property that involves mixed consumer and business use would also be a problem, as would verifying that retail goods were not purchased for personal use by business representatives (e.g., a bar owner purchasing a flat-screen for home).

Previous studies have found a 13 percent "delinquency" rate for state sales taxes. This rate of evasion is lower than the likely rate under a national retail tax, though, since the tax rate under a national plan would be significantly higher than the rates applied by the states, increasing the incentive to cheat. Underreported sales would almost certainly be much higher with a national retail tax for two reasons: (1) enforcing the income tax currently relies on cross-verification between federal and state income taxes, and (2) the effective sales tax rates are currently low. With a tax-regime change, both of these conditions would change.

How Could We Improve the Federal Tax System?

Would tax evasion and avoidance be a significant problem with a national retail sales tax?

Then there's the question of taxing 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 sales tax if he took the funds and bought, say, an expensive car. The flaw in this argument was laid out years ago by former Congressman Richard "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 [illegal] drug trade."

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What would be the effect of a national retail sales tax on economic growth?

Q. What would be the effect of a national retail sales tax on economic growth?

A. The switch from an income tax to a consumption-based tax would probably make a positive difference, but it is far from certain.

A pure retail sales tax without exemptions or transition relief ought to have a positive impact on growth. First, switching from an income tax to a consumption-based tax would lead to greater savings and investment. And that should increase productivity and the pace of output growth.

There's a subtler route, too. The effective double taxation of existing capital during the transition to a national retail sales tax would generate windfall revenues and thus allow a tax-rate reduction that stimulated growth.

However, the world is not quite that simple. Many forms of saving—including pensions, 401(k) plans, and individual retirement accounts—already receive consumption tax treatment, and a significant share of corporate income is already untaxed. Moreover, under a national retail sales tax, the likely provision of transition relief for existing assets could reduce the effect on saving further (it's hard to imagine that sophisticated lobbies would accept double taxation without a fight).

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 (2001), simulates the effects of moving from the current system to a flat-rate consumption tax.

Their analysis—which assumes a less generous cash demogrant (cash rebate) than proposed by national retail sales tax advocates, some 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 10 years, and 3.6 percent larger in the very long run. But here, as almost everywhere, the devil is in the assumptions. Plausible allowances for avoidance, evasion, and erosion of the statutory tax base for political reasons, along with the incorporation of a more generous demogrant, would reduce these estimates.

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Q. What transition rules would be needed for a national retail sales tax?

A. The answer depends more on politics than economics.

Any fundamental tax reform that seeks to collect the same amount of revenue in a new way is almost certain to redistribute tax burdens, affect asset values, and change price levels. Those who stand to lose would try to prevent the reform or secure "transition relief" that delays or blunts the impact.

The national retail sales tax proposal illustrates these issues starkly. Could the proposal withstand inevitable political pressures to provide preferential treatment to some interests or to introduce transition relief? The issue is pivotal because backsliding would undermine the logic of pressing the reform in the first place.

The transition issues with a national sales tax constitute a can of worms. At one extreme, the sales tax could include no adjustments. At the other, policymakers could grant extensive relief by adjusting Social Security benefits to reflect higher retail prices, allowing consumption to be tax-free if financed by existing wealth, and so forth. In practice, the transition relief that has accompanied much smaller tax reforms has tended to balloon.

The economic case for transition relief depends on how it affects the simplicity, efficiency, and equity of the new tax system. Providing no relief would be simpler; transition rules could prove complex, and the transition period could stretch out for years. However, there are wheels within wheels here. Not providing relief would also be problematic because it would create strong incentives for individuals to adjust their behavior before the tax takes effect.

Not providing transition relief would certainly be more efficient. A consumption tax that exempts old assets is just a tax on future wages. While 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. Not taxing existing assets requires higher tax rates on the rest of the tax base to raise the same revenue, increasing the disincentives to work that dog any tax on wages.

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 their owners to change the rules in midstream?

How Could We Improve the Federal Tax System?

What transition rules would be needed for a national retail sales tax?

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 the overall distribution of wealth. And the overall distribution of wealth is, in turn, more skewed toward the wealthy than the distribution of income. Second, since wealthy households would benefit most from the switch to a consumption-based tax, it seems reasonable to ask them to pay some of the costs.

Third, older households tend to have more assets than younger ones, so taxing existing capital places heavier burdens on older generations. But there's rough justice here: those older households, on average, 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 reform), 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 it was part of the package. And history strongly suggests that it would. Even in much smaller tax reforms, the losers—households and businesses made worse off by the reform—have been compensated. A big question, then, is whether imposing what might be called "sales tax lite" would be worth the economic dislocation.

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How Could We Improve the Federal Tax System?

Would a national retail sales tax simplify the tax code?

Q. Would it simplify the tax code?

A. It would for individuals, but not so much for businesses and enforcement authorities.

OVERVIEW

Constructed as a flat-rate consumption tax with a universal demogrant (cash payment) for needy 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, learn the fundamentals of tax law, or even file returns. Only sole proprietorships, partnerships, and S or C corporations that make retail sales would have to file. And the complexity of filing a return would decline dramatically, even for these taxpayers.

But a national retail sales tax could create new areas of complexity in, for example, administering the proposed demogrant that returns part of the revenue to millions of households, enforcing the tax code to ensure that personal and business consumption are not mixed.

DEMOGRANTS

In many proposals, the demogrant that would accompany a national retail sales tax would likely be based on the existing federal poverty guidelines, which rise less than proportionally with the number of family members. For example, in 2016, single individuals fell beneath the federal poverty level if their annual incomes were less than $11,880. This number rose by $4,140 for each additional family member. Thus the federal poverty level for a family of four in 2016 was $24,300, roughly twice the level for an individual. Basing the demogrant on the federal poverty level would thus create incentives to conceal family relationships to claim the demogrant for more than one individual in a family.

ADMINISTRATION

It is also unclear 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.

How Could We Improve the Federal Tax System?

Would a national retail sales tax simplify the tax code?

TAX AVOIDANCE AND EVASION

Another area of 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 purchase goods for personal use with 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. Some proposed tax plans 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. Such requirements would raise compliance costs further.

EVIDENCE

Some related evidence on the potential extent of these problems comes from the experience with state-level "use" taxes, under which taxpayers are obliged to make tax payments on goods purchased in other states. One analyst described the current level of enforcement of such taxes as "dismal at best."

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Q. What has been the state and local experience with retail sales taxes?

A. Most states and localities rely heavily on retail sales taxes. But their experiences suggest that administering a national tax would be daunting.

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. Sales taxes are now the rule rather than the exception in states and localities: 45 states, the District of Columbia, and several thousand localities impose them. Only Alaska, Delaware, Montana, New Hampshire, and Oregon abstain. Sales tax rates vary widely (from 3 percent to 8 percent), as do the goods and services that are exempt.

Nothing in the states' experience suggests that a broad-based, high-rate federal retail sales tax would survive attempts to create preferences or be easy to administer. For example, states show little inclination to carefully differentiate between producers' and consumers' purchases. But without a uniform exemption of producer purchases in a national retail sales tax, market distortions 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 plain old lobbying. The federal base would have to be much broader than the typical state base; otherwise, the rate needed to replace the revenue generated by today's income tax would be sky-high. The states offer only limited experience in taxing government entities. But proposals for a national tax envision taxing every dollar of government purchases and investment.

A uniform retail sales tax would cover consumption of all goods and services. State sales taxes, however, deviate from this norm in numerous ways. According to a 2010 Federation of Tax Administrators (FTA) survey, 35 states exempted household water usage, 25 states exempted household electricity, 21 exempted household natural gas, and 21 exempted household telephone services. Another FTA 2015 survey revealed that 33 states exempted food and almost all states exempted prescription medicines. Taxation of services under state sales taxes is spotty at best.

Product exemptions intended to make the tax more progressive would be deeply problematic. Demogrants, (cash rebates for lower-income families) 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 exemptions for "worthy" goods like prescription drugs and heating fuel are quite popular, pleasing policymakers because they appear progressive even as they serve the interests of the producers looking for exemptions.

How Could We Improve the Federal Tax System?

What has been the state and local experience with retail sales taxes?

The state experience suggests that items that are difficult to tax are sooner or later excluded and, again, that political pressures can easily affect the form and substance of a retail sales tax.

The taxation of services is even more problematic. Although many states tax some services, only Hawaii and New Mexico include almost all services in the tax base. Enforcement of sales taxes on services has proved exceptionally difficult. These taxes are hard to administer and easy to evade because their paper trail is difficult to audit. This challenge raises several red flags for a national retail sales tax.

Last but not least, remember that an efficient retail sales tax should exempt all business purchases, but most state-level sales taxes do not come close to this ideal. Various 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 are as high as 70 percent.

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Q. What is the experience of other countries with national retail sales taxes?

A. No country has attempted a truly ambitious retail sales tax. Those that have tried more modest versions have abandoned them in favor of value-added taxes.

Many countries have attempted to implement national retail sales taxes or variants, such as wholesale-level taxes or "ring" taxes (retail sales taxes with exemptions for businesses "in the ring"). But not for long. In 1967, 19 Organisation for Economic Co-operation and Development (OECD) countries had some form of wholesale, retail, or turnover tax. By 1995, all had converted to value-added taxes (VATs) that collect revenue at each stage of production. Developing countries have also largely abandoned retail sales taxes in favor of VATs.

Retail sales tax rates are generally lower than VAT rates, running 4–6 percent as opposed to 14–25 percent. These sales tax rates are 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 retail sales taxes with rates in excess of 10 percent. And none of these countries currently maintains such a tax, presumably because high-rate sales taxes invite evasion.

There are good reasons retail sales taxes get replaced with VATs; namely, evasion and "cascading." 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 effect can be avoided by exempting all business purchases from taxation. But separating business purchases from consumer purchases is difficult. Moving to a VAT solves the problem since businesses receive credits for the taxes paid on their input purchases.

Evasion is higher under a retail sales tax than under a VAT for several reasons. First, the retail level is the weakest link in the enforcement chain. Second, if a retailer evades a sales tax, the full tax on the sale is lost. But with a VAT, successful evasion by retailers only costs the government the tax on the retailer's value added. Third, with sales taxes, there is no paper trail that enforcers can easily follow.

How Could We Improve the Federal Tax System?

What is the experience of other countries with a national retail sales tax?

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Q. Why wouldn't the rate for a national retail sales tax be 23 percent?

A. A mix of evasion and exemptions would almost certainly erode the tax base. More plausible estimates show that the rate needed to replace existing revenues would be well above 30 percent.

Advocates of a national retail sales tax have suggested that a broad-based version with a 23 percent rate would generate sufficient revenue to replace the entire federal tax system. But this number is misleadingly low for several reasons. It assumes that

1. there is no evasion;
2. no effort would be made to legally avoid the tax; and
3. no items, not even exceptionally difficult-to-tax goods and services, would be excluded from the base.

Note, moreover, that the 23 percent rate cited is a "tax-exclusive" rate. This corresponds to a 30 percent rate when calculated in a "tax-inclusive" fashion, the way income taxes are assayed. Consider, too, that the 23 percent rate is flawed: the calculation is based on a mathematical error in the way advocates computed the changes in consumer and producer prices that would occur under their proposed tax.

Thus, as table 1 suggests, a more plausible calculation of the rate needed to replace other federal taxes would be much higher.

TABLE 1
Required Tax Rates

	Tax inclusive rate	Tax exclusive rate
Maintain real federal revenues and primary spending	31%	44%
Effects of base erosion/rate broadening	39%	65%

Source: Gale (2005).

Further Reading

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President's Advisory Panel on Tax Reform. 2005. *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System.* Washington, DC: President's Advisory Panel on Tax Reform.

Q. What did the President's Advisory Panel on Tax Reform say about the national retail sales tax?

A. Put simply: a nonstarter.

The President's Advisory Panel on Tax Reform's first objection to replacing the current tax system with a national retail sales tax hinges on the latter's effect on income distribution. The report (2005) noted that "lower and middle-income families would be especially hard hit by a standalone retail sales tax."

The panel was also concerned that, although the proposed demogrant program (which would provide cash rebates to needy households) would make the retail tax system less regressive, it would be a bear to administer. And it would thus "inappropriately increase the size and scope of government." Moreover, the panel concluded that, with the demogrant, the tax rate needed to sustain current federal revenues would exceed—perhaps far exceed—34 percent. Meanwhile, households would still be liable for state and local sales taxes, which currently average 6.5 percent.

Nor was the panel impressed with the tax's value as a tool to simplify the tax system. Taxpayers would still be required to complete state income tax returns unless states abolished their own income taxes. Moreover, a new government agency would be required to monitor both the collection of the tax and the allocation of demogrants to families.

The panel also expressed concern about the likely level of evasion: "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." And with third-party reporting—such as W-2 and 1099 forms—notably absent from the proposal, "evasion rates are estimated to be around 50 percent."

There's more glum news here. The panel noted that states would lack the ability to collect the tax and that an agency analogous to the IRS would be needed to enforce compliance. It also pointed out that states currently rely on taxpayers' fears of audits of federal income tax returns to deter evasion. If the federal government abandoned income tax enforcement along with the income tax, states would be left hanging. Lastly, the report cited concern that the burden of collecting the tax would disproportionately fall on small businesses and small service providers, raising their costs.

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Q. What is a VAT?

A. The value added tax (VAT) is the world's most common form of consumption tax, in place in more than 160 countries, including every economically advanced nation except the United States.

"Value-added" is the difference between business sales and purchase of goods and services from other businesses. It represents the sum of wages, other labor compensation (such as health insurance), interest payments, and the profits that businesses earn.

For example, suppose a farmer grows wheat and sells it to a baker for $40. The baker turns the wheat into bread and sells it to consumers for $100. The baker's value added is $60—the difference between sales and purchases. Let's further assume that the farmer has no input costs so that his value added is $40. The sum of value added at each stage of production is equal to the retail sale price of the good, in this case $100.

Governments can tax value added in different ways—the credit-invoice method is most common but Japan uses the subtraction method to assess their VAT.

The VAT is popular because it raises significant amounts of revenue, is relatively easy to administer, and, unlike an income tax, does not impinge on household saving and business investment choices. In 2012, VAT revenues averaged 5.6 percent of gross domestic product in OECD countries, the third largest revenue source after income and payroll taxes.

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Q. How would a VAT be collected?

A. Most countries with a value-added tax (VAT) employ the credit-invoice method. Under this method, businesses are taxed on their sales at each stage of production, but obtain credits for the taxes they paid on their inputs.

CREDIT-INVOICE METHOD

Most countries with a value-added tax (VAT) employ the credit-invoice method. All sales by businesses are taxable, but sellers pass on invoices to the VAT-registered business taxpayers who purchase goods and services from them. These purchasers, in turn, claim a credit for taxes paid on their purchases, but then pay VAT on the full value of their sales. The result is that there are no net taxes on sales between registered VAT businesses, while the full value of the final sale to the consumer bears tax (table 1).

TABLE 1

Prices with Different Types of 10 Percent Sales Taxes

Taxes paid in parentheses

Production stage	No tax	Retail sales tax	Credit invoice VAT	Subtraction method VAT
Farmer	$300	$300 ($0)	$330 ($30)	$330 ($30)
Miller	$700	$700 ($0)	$770 ($70–$30)	$770 ($40)
Baker	$1,000	$1,100 ($100)	$1,100 ($100-$70)	$1,100 ($30)
Total Tax	**$0**	**$100**	**$100**	**$100**

Source: Toder and Rosenberg, 2010.

SUBTRACTION METHOD

Under a subtraction-method VAT, sometimes called a business transfer tax, businesses pay tax on the difference between the value of their sales and the value of their purchases from other businesses. As with the credit-invoice VAT, the sum of all the amounts subject to tax, without exemptions, is equal to the value of final sales. Japan uses a subtraction-method VAT, but it contains all the invoice requirements and rules of the credit-invoice method, so in practice it is not that different from the VATs used in other countries.

How Could We Improve the Federal Tax System?

How would a VAT be collected?

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Q. What would and would not be taxed under a VAT?

A. Typically, a value-added tax covers all or most forms of consumption.

In principle, the net tax base of a value-added tax (VAT) is all consumption. Most VAT systems, however, exclude certain items from taxation. Some items (e.g., food and prescription drugs) are excluded to reduce the impact of the tax on low-income households. Others are excluded because defining their "value-added" is difficult (e.g., financial services).

BROAD V. NARROW BASES

Eric Toder and Joseph Rosenberg (2010) provide examples of broad- and narrow- based VATs. The broad-based VAT they examine includes "all domestic consumption, except for education, government-financed health care (Medicare and Medicaid), services of charitable organizations, and services performed by sub-national governments," capturing about 80 percent of consumption. Their narrow-based VAT excludes (in addition to the exemptions in the broad-based VAT) "housing consumption, food consumed at home, and private medical expenses (out-of-pocket expenses and insurance premiums)," capturing about 50 percent of consumption.

REVENUE RATIOS

A revenue ratio is a formal measure of how broad a tax base is. For a VAT, the revenue ratio is calculated by dividing VAT revenue by the product of the standard VAT rate and all consumption. If the standard tax rate applied to all consumption and to nothing else, and if there were no evasion, the ratio would be one. The presence of zero-rated, exempt, or preferentially taxed goods reduces the revenue ratio, as does tax evasion.

The unweighted average VAT revenue ratio was 0.55 across all OECD countries in 2014, suggesting significant erosion in VAT revenues. The ratio ranged from 0.31 (Mexico) to 1.13 (Luxembourg).The combination of Luxembourg's status as a center of financial services and e-commerce and the current tax treatment of those services may explain why its VAT revenue ratio is greater than one.

The older VATs, mainly in European Union countries, have relatively narrow tax bases, with many goods or services receiving preferential treatment. Newer VATs, such as in New Zealand and Japan, tend to apply a lower standard rate to a broader base of goods and services.

How Could We Improve the Federal Tax System?

What would be taxed under a VAT?

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Q. What would the rate be under a VAT?

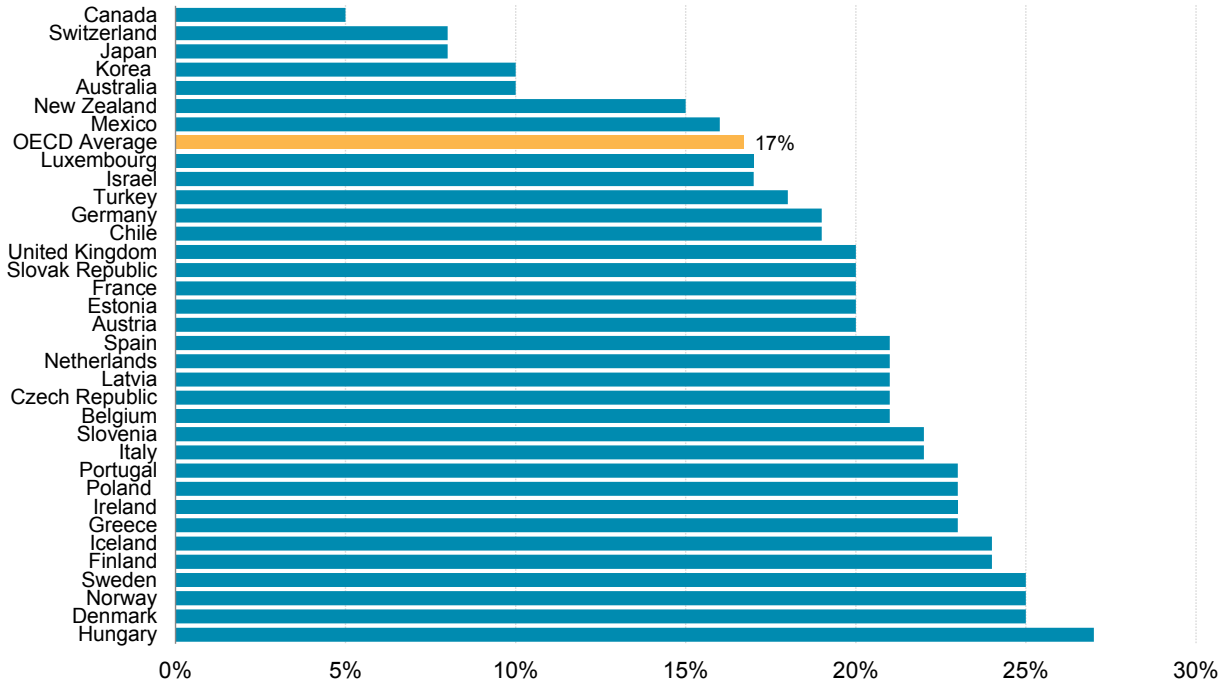
A. The rate of a value-added tax (VAT) depends on how much revenue it is intended to raise and how broad the VAT base is. The lower the revenue target and the broader the base, the lower the tax rate will be.

Value-added taxes (VATs) typically have a standard rate that applies to most goods and services. In 2016, the standard rate in the OECD averaged 16.7 percent but varied widely—27 percent, its highest level, in Hungary, 20 percent in the United Kingdom, 15 percent in New Zealand, 10 percent in Australia, 8 percent in Japan, and 5 percent, its lowest level, in Canada.

FIGURE 1

Value-Added Tax Rates

Among select OECD countries, 2015



Source: OECD, 2016.

How Could We Improve the Federal Tax System?

What would the rate be under a VAT?

VATs typically provide preferential treatment for certain goods. Some goods are zero rated, some goods are exempt. Some are taxed at preferential rates. The VATs in European Union countries have relatively narrow tax bases, with many goods or services receiving preferential treatment. Newer VATs, such as in New Zealand and Japan, tend to apply a lower standard rate to a broader base of goods and services. The broader the base, the lower the tax rate will be for a given revenue target.

Toder and Rosenberg (2010) estimated that the United States could have raised gross revenue of $356 billion in 2012 through a 5 percent VAT applied to a broad base that included all consumption except spending on education, Medicaid and Medicare, charitable organizations, and state and local government—capturing about 80 percent of consumption. That amount of revenues would equal about 2.3 percent of GDP. If the same 5 percent rate applied to a narrow base that also excluded housing consumption, food consumed at home, and private medical expenses (out-of-pocket expenses and insurance premiums)—capturing about 50 percent of consumption—revenues would have been $221 billion, equal to about 1.4 percent of GDP.

Data Source

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How Could We Improve the Federal Tax System?

What is the difference between zero rating and exempting a good in the VAT?

Q. What is the difference between zero rating and exempting a good in the VAT?

A. For a "zero-rated good," the government doesn't tax its sale, but allows credits for the value-added tax (VAT) paid on inputs. If a good or business is "exempt," the government doesn't tax the sale of the good, but producers cannot claim a credit for the VAT they pay on inputs to produce it.

ZERO RATING

Almost all countries apply preferential rates to some goods and services, making them either "zero rated" or "exempt." For a "zero-rated good," the government doesn't tax its retail sale, but allows credits for the value-added tax (VAT) paid on inputs. This reduces the price of a good. Governments commonly use zero-rated goods to lower the tax burden on low-income households by zero-rating essential goods, such as food and utilities or prescription drugs.

EXEMPTING

If, by contrast, a good or business is "exempt," the government doesn't tax the sale of the good, but producers cannot claim a credit for the VAT they pay on inputs to produce it. Because exempting breaks the VAT's chain of credits on input purchases, it can sometimes raise prices and revenues. Hence, governments generally only use exemptions when value-added is hard to define, such as with financial and insurance services.

IN PRACTICE

Of the 33 OECD countries with a VAT in 2015, 18 "zero rated" certain goods and 24 applied at least one nonzero reduced rate to a subsector of goods.

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Q. Who would bear the burden of a VAT?

A. A VAT is a tax on consumption. Because poorer households spend a larger proportion of their income, a VAT is regressive if measured relative to current income and if it is introduced without other policy adjustments. A VAT is less regressive if measured relative to lifetime income.

Although a value-added tax (VAT) taxes goods and services at every stage of production and sale, the net economic burden is like that of a retail sales tax. Sales taxes create a wedge between the price paid by the final consumer and what is received by the seller. Conceptually, the tax can either raise the total price (inclusive of the sales tax) paid by consumers or reduce the amount of business revenue available to compensate workers and investors. Theory and evidence suggests that the VAT is passed along to consumers via higher prices. Either way, the decline in real household income is the same regardless of whether prices rise (holding nominal incomes constant) or whether nominal incomes fall (holding the price level constant).

REGRESSIVITY

Because lower-income households spend a greater share of their income on consumption than higher income households do, the burden of a VAT is regressive when measured as a share of current income: the tax burden as a share of income is highest for low-income households and falls sharply as household income rises. Because income that is saved today is generally spent in the future, the burden of a VAT is more proportional to income when measured as a share of income over a lifetime. Even by a lifetime income measure, however, the burden of the VAT as a share of income is lower for high-income households than for other households because a VAT (like any consumption tax) does not tax the returns (such as dividends and capital gains) from new capital investment and income from capital makes up a larger portion of the total income of high-income households.

AVERAGE TAX BURDEN

Using a method that is more reflective of lifetime burdens, Eric Toder, Jim Nunns, and Joseph Rosenberg (2012) estimate that a 5 percent, broad-based VAT would be regressive at the bottom of the income distribution, roughly proportional in the middle, and then generally regressive at the top. The tax would impose an average tax burden of 3.9 percent of after-tax income on households in the bottom quintile of the income distribution. (Each quintile contains 20 percent of the population ranked by income). Yet, households in the top 1 percent of the income distribution would only have an average tax burden of 2.5 percent (Table 1).

How Could We Improve the Federal Tax System?

Who would bear the burden of a VAT?

TABLE 1

Distribution of a Fully Phased in VAT at 2015 Income Levels
(percentage change in after-tax income)

Cash Income Percentile	VAT Options		
	Broad Base	Narrow Base	Broad Base with Rebate
Lowest Quintile	-3.9	-3.8	-0.6
Second Quintile	-3.6	-3.5	-1.8
Middle Quintile	-3.6	-3.6	-2.9
Fourth Quintile	-3.6	-3.6	-3.5
Top Quintile	-2.9	-2.9	-3.7
All	-3.3	-3.3	-3.2
Addendum			
80-90	-3.4	-3.4	-3.8
90-95	-3.2	-3.2	-3.8
95-99	-2.8	-2.8	-3.6
Top 1 percent	-2.5	-2.5	-3.6
Top 0.1 percent	-2.5	-2.6	-3.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-7).

DEMOGRANTS

Exempting, zero rating, or excluding certain essential consumption goods from the tax base (e.g., foodstuffs, medicine, health care) can reduce the regressivity of a VAT. Giving preferential treatment to particular goods, however, is an inefficient way to make the tax less regressive because high-income households consume more of the goods in question (though less as a share of income) than low-income households do. A better approach is to provide a cash payment—that is, a demogrant or a refundable tax credit—of a limited amount. That way, everyone receives the same benefit, in dollars, which translates into a larger share of low-income households' income.

In the same study, Toder, Nunns, and Rosenberg simulate the effects of a 7.7 percent broad-based VAT with a refundable tax credit (the higher tax rate keeps the net revenues the same as the 5 percent, broad-based VAT with no tax credit). They find that the VAT in combination with the tax credit would impose an average tax burden of 0.6 percent on households in the bottom quintile of the income distribution. Households in the top 1 percent of the income distribution would face an average tax burden of 3.7 percent. Their results also show that the distribution of a narrow-based VAT that excludes spending on food, housing, and health care is much the same as the distribution of a broad-based tax.

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Q. Is the VAT a money machine?

A. A common criticism of the value-added tax is that it is simply a "money machine" that will enlarge the federal government by supplying a steady source of federal revenue. The empirical evidence has largely shown that this has not been the case.

Critics provide various reasons a value-added tax (VAT) would enlarge government. First, they say that any increase in government revenues will lead to more spending. If we want to control government spending, they say, we should cut revenues and "starve the beast." Second, critics fear that because a VAT is a "hidden tax," buried in the price of a good, policymakers can raise the tax with minimal economic disruption and without people noticing.

The accumulated track record of VATs, however, largely belies these concerns. For starters, VAT revenues and rates have not risen inexorably over time. In advanced countries, VATs were phased in during the 1960s and 1970s. But after that, as International Monetary Fund economist Michael Keen has shown, VAT revenues remained remarkably constant for a long time, hovering around 7 percent of gross domestic product (GDP) in the 1990s and 2000s. VAT revenue among high-income countries in 2009 was almost exactly the same share of GDP as in 1993 (Keen, 2013; Keen and Lockwood 2006).

Furthermore, although overall revenues have risen in European countries since the VAT was introduced, the VAT does not appear to be the cause. From 1965 to 2012, VAT revenue rose by 5.6 percent of GDP in 16 European countries. That's an enormous increase in revenues but it was accompanied by a reduction of 5.2 percent of GDP in excise and other sales taxes. As a result, less than 10 percent of VAT revenue—0.4 percent of GDP—went for purposes other than reducing sales taxes.

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Q. How would small businesses be treated under a VAT?

A. Most countries exempt small businesses from value-added tax, although many small business choice voluntarily to register for the VAT.

Most countries exempt small businesses from a value-added tax (VAT)—partly because small business is a powerful political constituency and partly because the administrative and compliance costs of taxing small businesses are high relative to the revenue raised.

The exemption is a mixed blessing, however. Many businesses prefer to buy their inputs from businesses that are in the VAT system so they can claim credits on the tax they pay. As a result, countries allow small businesses to register for the VAT even if they are not required to do so. For example in Australia during the 2010–11 tax year, 37 percent of businesses had sales below the VAT threshold, yet 92 percent of all businesses registered for the VAT.

A higher exemption based on business sales saves on compliance costs but reduces revenue, with the revenue loss depending on the tax rate. A recent study by Treasury Department economists finds that with a 10 percent VAT in the U.S., the optimal exemption level based on sales would be about $200,000 and would exempt about 43 million businesses (Brashares et al.). That exemption would be higher than in most other countries, but the 10 percent rate would be lower than in most other countries. At a 20 percent rate, which is close to the OECD average, the optimal exemption would be $90,000, which is within the range of exemptions in other countries.

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Q. What is the Canadian experience with a VAT?

A. Concerns about regressivity, transparency, coordination with state sales taxes, and money machines can be assuaged by observing the Canadian value-added tax experience.

In 1991, Canada implemented a 7 percent national VAT to replace a tax on sales by manufacturers. The VAT was introduced by the conservative party, which had concerns about industry competitiveness and the country's fiscal situation.

Canada addressed distributional concerns by applying a zero rate to certain necessities—including groceries, drugs, and rent—and adding a refundable credit to the income tax. Transfer payments had been indexed for inflation and were highly progressive, providing further insulation against regressivity.

The Canadian VAT is completely transparent: it is listed separately on receipts and invoices just like sales taxes in the United States.

The Canadian experience also shows that a federal VAT can successfully coexist with either a VAT or a retail sales tax levied by subnational governments.

And the VAT in Canada has not been anything like a "money machine." The standard VAT rate declined over time to 6 percent in 2006 and 5 percent in 2008. In both revenues and expenditures, the size of the Canadian federal government as a share of the economy has shrunk significantly since introduction of the VAT. General government tax revenue and spending in Canada has actually fallen as a share of the economy since 1991.

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How Could We Improve the Federal Tax System?

Why is the VAT administratively superior to a retail sales tax?

Q. Why is the VAT administratively superior to a retail sales tax?

A. Retail sales taxes suffer from several enforcement problems. Most notably, the government has no record of transactions with which to verify retailers' tax payments. In a value-added tax, the chain of crediting creates a natural audit trail, and the seller has more incentive to report the transaction and pay tax.

If the value-added tax (VAT) replicates the effect of a well-functioning sales tax, why not just enact a retail sales tax?

Retail sales taxes suffer from several enforcement problems. Most notably, there's no cross reporting; the government has no record of the transaction and the retailer responsible for sending the check to the government for the tax it collects knows this.. As a result, compliance rates can be low. Most countries have found that, as a practical matter, retail sales tax rates of 10 percent or higher aren't enforceable—buyers have greater incentives to avoid the tax and retailers have greater incentive not to send in the revenues. Not coincidentally, all state sales tax rates are below 10 percent.

For any tax, cross reporting is essential to keep compliance rates high. In the income tax, firms withhold income and payroll taxes on behalf of workers and send the money to the government. As a result, evasion rates on wage income are low. The exception is tips, which serves to prove the point. In the VAT, the chain of crediting creates a natural audit trail. In a transaction between two businesses, the seller knows the buyer is reporting the transaction to claim a credit, so the seller has more incentive to report the transaction and pay tax. There's no similar incentive under a retail sales tax.

Also with a sales tax, the retailer can't always tell whether the buyer is a consumer who should pay the tax or a business which should not—and has little incentive to find out. If the retailer doesn't impose a sales tax on consumer purchases, that's tax evasion. If the retailer does impose a tax on business purchases, the tax "cascades," building up over successive stages of production, which raises and distorts prices depending on the number of stages of production. By providing a credit for taxes paid, the VAT prevents cascading. Last, when there is evasion at the retail level, tax revenues are lost entirely with a sales tax. With a VAT, revenue is only lost at the "value-added" retail stage. All these differences help explain why numerous countries replaced their sales and turnover taxes with VATs.

How Could We Improve the Federal Tax System?

Why is a VAT administratively superior to a retail sales tax?

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Q. What is the history of a VAT?

A. The value-added tax (VAT) is a relatively new tax. It was designed by two people, independently, in the early 20th century. Many European countries enacted a VAT in the 1960s and 1970s. Developing countries followed in the 1980s and thereafter.

The value-added tax (VAT) is a relatively new tax. It was designed by two people, independently, in the early 20th century. To Wilhelm Von Siemens, a German businessman, the VAT was a way to resolve the cascading problems that arose in implementing gross turnover taxes and sales taxes. To Thomas S. Adams, an American, the VAT was a better version of the corporate income tax.

In practice, governments have implemented the VAT largely as an improved sales tax. European countries, for example, have largely used the VAT to reduce or eliminate other sales taxes. They continue to maintain separate corporate income taxes.

Many European countries enacted a VAT in the 1960s and 1970s. Developing countries followed in the 1980s and thereafter. Sijbren Cnossen, a leading VAT expert from Maastricht University in the Netherlands, called its spread "the most important event in the evolution of tax structure in the last half of the 20th century" (1998).

US policymakers have found it tempting to consider the VAT, but no one seems to be able to muster the courage to call it by its real name. In recent years, VATs have been proposed by current House Speaker and former Republican vice presidential nominee Paul Ryan (who called it a "business consumption tax"), libertarian Kentucky senator Rand Paul (as part of his "Fair and Flat Tax"), Republican presidential candidate Herman Cain (one of the 9s in his "9-9-9" proposal), Senate Finance Committee Democrat Ben Cardin (who called it a "progressive consumption tax"), and the Bipartisan Policy Center's Domenici-Rivlin 2010 commission report (as a "deficit reduction sales tax").

How Could We Improve the Federal Tax System?

What is the history of a VAT?

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Q. How are different consumption taxes related?

A. A retail sales tax, value-added tax, the flat tax, and the X-tax are closely related taxes. These taxes are contrasted with wage taxes.

A retail sales tax is a flat-rate tax on all sales from businesses to households. A value-added tax (VAT) is equivalent to a retail sales tax but it collects the tax in small pieces at each stage of production rather than entirely at the final sale. The Hall-Rabushka flat tax is simply a two-part VAT, with all value added except wages taxed at the firm level and wages taxed at the individual level, after allowing for exemptions based on family size. Businesses and individuals face the same flat rate on all income. The X-tax is simply a variant of the flat tax in which wages are taxed at graduated rates, and the business tax is set equal to the highest rate on wages.

A wage tax is quite different. It would tax wages directly, as would the flat tax or X-tax, but it would not contain the business component of such taxes.

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Q. What is the flat tax?

A. While any tax system with flat rates could be called a flat tax, the name "flat tax" is usually reserved for a system developed by Robert Hall and Alvin Rabushka in a 1985 book. Their flat tax is really a two-part VAT, with all value added except wages taxed at the business level and wages taxed at the individual level at the same flat rate, but with an exemption related to family size.

The Hall-Rabushka flat tax would replace the current income tax system with a consumption tax. Their system is a two-part value-added tax (VAT). All value added, except wages, which would be deductible, would be taxed at the business level. Wages would be taxed at the individual level, with an exemption based on family size. All taxable wages and all business nonwage value added would face the same flat rate. In Hall and Rabushka's original proposal, that rate would be 19 percent (1985).

In short, the flat tax is a consumption tax, even though it looks like a wage tax to households and a variant of a VAT to most businesses. Therefore, other than the exemptions, the economic effects of the flat tax are essentially the same as those of a VAT or a sales tax.

The flat tax can be split into two parts: the business tax and the individual tax. Firms would be responsible for paying taxes (at a flat rate) on sales after they have deducted wages, pensions, material costs, and capital investments. Individuals would be responsible for paying taxes (again, at a flat rate) on the wages that firms have deducted, but only on wages in excess of an exemption level.

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Q. What is the X-tax?

A. The X-tax is a variant of the flat tax developed by economist David Bradford. It is mechanically identical to the flat tax, except that it incorporates graduated tax rates on household wage income to improve progressivity.

The X-tax is a variant of the flat tax developed by Princeton economist David Bradford (1986). Like the flat tax, it is consumption based and incorporates two elements: a business tax and a personal tax.

On the business side, firms would be responsible for paying taxes on their sales, less material costs and wages; the business tax rate would be set equal to the highest tax rate on the individual side. On the individual side, individuals or households would be taxed on wages, less a deduction based on family size. The individual tax would have graduated tax rates up to a maximum equal to the business rate.

The major difference between the flat tax and the X-tax is the inclusion of a graduated individual rate structure on wages. This makes the X-tax more progressive in comparison to the flat tax.

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Q. What was included in *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, Report of the President's Advisory Panel on Federal Tax Reform, November 2005?

A. The President's Advisory Panel on Federal Tax Reform recommended two simpler and fairer alternatives to the US income tax system, but both come with some big catches.

The President's Advisory Panel on Federal Tax Reform was created by President Bush in 2005 to recommend options to make the tax code simpler, fairer, and more conducive to economic growth. The panel developed two proposals, outlined below. Both contain features of income and consumption taxes, simplify taxes and streamline filing, eliminate the alternative minimum tax, eliminate most tax expenditures, and decrease the effective tax rate on capital income. As directed by the President, the panel designed the plans to be revenue neutral, though with the assumption that tax cuts proposed in President Bush's budget would be enacted.

The core chapters outline the panel's Simplified Income Tax Plan and the Growth and Investment Tax Plan, and how a value-added tax might be added to the former. The final chapter examines the possibility of replacing the income tax with a retail sales tax and finds that doing so would be deeply problematic.

SIMPLIFIED INCOME TAX PLAN

The Simplified Income Tax Plan (SIT) would streamline the tax code by eliminating several exemptions. It would lower individual income tax rates to a range of 15–33 percent and cut the top corporate rate to 31.5 percent. And it would encourage greater use of Roth-style savings accounts, such that a family of four could contribute up to $60,000 per year in plans for retirement, health, education, and housing.

MAJOR CHANGES TO TAX EXPENDITURES

- Replace the standard deduction, personal exemption, and head-of-household family credit with a single family credit.
- Replace the earned income tax credit (aimed at the working poor) with a less generous version.
- Convert the mortgage interest deduction to a 15 percent credit and reduce the cap on eligible interest payments to increase the number of people qualifying for the credit by 60 percent.
- Allow any taxpayer to deduct charitable contributions in excess of 1 percent of income.
- Eliminate the state and local tax deduction.
- Allow nongroup health insurance plans to be deductible up to the amount of the average premium. Employer-paid premiums in excess of caps would be taxable.

How Could We Improve the Federal Tax System?

Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, November 2005

SAVINGS AND RETIREMENT

- Replace all current tax-preferred savings options with three savings vehicles and a refundable saver's credit that phases out with increases in income. Each account would have a Roth-like structure (no initial deductions) and would not have income eligibility limits.
- Implement Save at Work plans that would consolidate all employer-provided defined-contribution plans and 401(k) plans, would encourage automatic contribution as a default, and would maintain the current 401(k) contribution limits.
- Implement Save for Retirement plans that would replace all non-employer-provided savings plans such as individual retirement accounts. They would have a $10,000 annual contribution limit.
- Implement Save for Family plans that would replace education and health savings plans and could be used for education, medical care, home purchases, and retirement. Up to $1,000 could be withdrawn each year for any purpose and up to $10,000 could be contributed annually.

CORPORATE TAXATION

- Divide businesses into small, medium, and large sizes, with separate rules for each.
- Eliminate most deductions and credits.
- Move to a territorial system that taxes only domestic income.
- Eliminate the income tax on dividends received from US companies.
- Exclude 75 percent of corporate capital gains received from US companies from personal taxation.
- Tax interest received at regular individual income tax rates.

GROWTH AND INVESTMENT PLAN

The Growth and Investment Tax Plan (GIT) alternative would move the system closer to a consumption tax. It would be composed of a hybrid X-tax (a tax that mixes a European-style value-added tax with an income tax on wages) plus an individual-level 15 percent surcharge on capital income. Most of the proposals in the SIT regarding major credits and deductions, as well as individual savings and retirement, would also apply to the GIT.

MAIN PROVISIONS

- The X-tax would be a flat 30 percent value-added tax-like levy with deductions for wages and other compensation. Investments would be expensed, interest and other financial inflows would not be taxed, and there would be no interest payment deductions.
- Individuals' interest, dividends, and capital gains would be taxed at 15 percent.
- All front-loaded 401(k) plans would be converted to back-loaded Roth plans.
- Individual income tax rates would be consolidated into three brackets with rates of 15, 25, and 30 percent.

ANALYSIS

Although the report claims that the proposals would have been revenue-neutral, this would only have been the case if President Bush's tax cuts in 2005 and beyond had become law. Relative to a baseline that assumed current law, the panel's proposals would lose revenue and make the tax system less progressive.

How Could We Improve the Federal Tax System?

Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, November 2005

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Q. What is included in *The Moment of Truth*, Report of the National Commission on Fiscal Responsibility and Reform, December 2010?

A. The 2010 report of the National Commission on Fiscal Responsibility and Reform recommends policy reforms, collectively known as the Bowles-Simpson plan, intended to stabilize America's fiscal path.

President Obama tasked the National Commission on Fiscal Responsibility and Reform with recommending ways to bring the federal budget back into balance and to improve its long-run viability. The commission created a six-part plan outlining comprehensive tax reform, Social Security reform, cuts in discretionary spending, health care cost containment, mandatory personal savings, and changes to the budget process.

As a whole, the plan would reduce the deficit to 2.3 percent of GDP by 2015, cap total revenue at 21 percent of GDP, and reduce spending to less than 22 percent of GDP. It would also stabilize the debt by 2014 and reduce the debt to 40 percent of GDP by 2035 (from about 60 percent when the report was written). The plan would cut the fiscal gap with an almost equal mix of revenue increases and spending cuts.

COMPREHENSIVE TAX REFORM

The commission's plan for tax reform set multiple goals: lower tax rates, broaden the base, cut tax expenditures, reduce the deficit, and maintain or increase tax progressivity.

Key Provisions

- Create three individual income tax brackets of 12, 22, and 28 percent, as well as a single 28 percent corporate rate.
- Eliminate the alternative minimum tax.
- Tax capital gains as normal income.
- Eliminate all tax expenditures except as follows:
  - Keep the child tax credit and earned income tax credit.
  - Replace the mortgage interest deduction with a 12 percent nonrefundable credit for all taxpayers for mortgages on principal residence only. Cap mortgage eligibility at $500,000.
  - Cap the exclusion for employer-sponsored health care at the 75th percentile of average premiums in 2014. Reduce the excise tax on high-cost health care plans (the Cadillac tax) to 12 percent.
  - Replace the charitable contribution with a 12 percent nonrefundable credit for contributions over 2 percent of adjusted gross income.

How Could We Improve the Federal Tax System?

The Moment of Truth, Report of the National Commison on Fiscal Responsibility and Reform, December 2010

  - Tax interest on newly issued state and municipal bonds.
  - Consolidate retirement accounts and cap tax-preferred contributions at the lower of $20,000 or 20 percent of adjusted gross income, while expanding the saver's credit.
- Eliminate all tax expenditures benefiting corporations.
- Implement a territorial tax system for active foreign-source income.
- Increase the excise tax on gasoline by 15 cents between 2013 and 2022.

SOCIAL SECURITY REFORM

To reduce Social Security's projected funding shortfall, the commission would increase the taxable wage base by 2050 to include 90 percent of earnings, to increase the full- and early-retirement ages to 69 and 64 respectively by 2075, to cover newly hired state and local workers after 2020, and to create a hardship exemption allowing those who cannot work past age 62 to receive benefits early. In addition, a chained consumer price index (which is generally lower) would be used to index benefits. To aid the lowest earners, the proposal included provisions to make the benefit formula more progressive and to create a minimum benefit for low-wage workers and the long-term disabled.

CUTS IN DISCRETIONARY SPENDING

The commission recommended that discretionary spending be capped through 2020 to force a reckoning of priorities, and that security and nonsecurity spending be reduced by equal percentages.

HEALTH CARE COST CONTAINMENT

The commission recommended changes to the Medicare Sustainable Growth Rate, a system designed to control Medicare payments to physicians. Other savings would come from changes in cost-sharing, malpractice law, and prescription drug costs. Overall, the commission recommended that health care spending growth be held to GDP plus 1 percent.

CHANGES TO THE BUDGET PROCESS

Finally, the commission proposed changes to the budgeting process, including switching to a chained consumer price index where cost-of-living indexes are used to set spending, establishing a debt stabilization process to enforce deficit reduction targets, allowing budgetary cap adjustments for program integrity efforts, and reviewing budget scoring practices.

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Debt Reduction Task Force, "Restoring America's Future," November 2010

Q. What was included in the Debt Reduction Task Force proposal, "Restoring America's Future," Bipartisan Policy Center, November 2010?

A. The task force proposed changes to the tax system, federal spending, health care spending, and Social Security to improve America's fiscal condition.

The Debt Reduction Task Force, chaired by Senator Pete Domenici and Alice Rivlin, created a plan to recover from the 2008 recession in the near term and reduce the national debt in the long term. The task force provided recommendations to reduce and stabilize the debt, streamline the tax code, restrain health care costs, strengthen Social Security, and freeze defense and domestic discretionary spending. The plan would reduce the debt to 60 percent of GDP by 2020 and balance the primary budget (excluding interest payments) by 2020. Federal spending would be reduced to 23 percent of GDP by 2020, with revenues at 21.4 percent of GDP.

REVIVE THE ECONOMY AND CREATE JOBS

The task force recommended a one-year payroll tax holiday to create between 2.7 and 7 million new jobs over two years.

TAX REFORM

The task force's plan would cut tax rates and broaden the base by eliminating tax expenditures and establishing a new debt reduction sales tax.

Major Reform Proposals

- Consolidate individual income tax rates into two brackets: 15 and 27 percent.
- Cut the corporate income tax rate to 27 percent.
- Tax capital gains and dividends as ordinary income, while allowing a $1,000 exclusion for capital gains.
- Eliminate the standard deduction and personal exemptions, along with most tax expenditures.
- Replace the earned income tax credit and other family and child provisions with a $1,600 per child universal credit and a credit of 21.3 percent on the first $20,300 of earnings for each worker.
- Replace the mortgage interest deduction and deduction for charitable contributions with 15 percent credits that are available to everyone regardless of income (the 15 percent mortgage interest credit would only be available for expenses on a principal residence, and only up to $25,000).

How Could We Improve the Federal Tax System?

Debt Reduction Task Force, "Restoring America's Future," November 2010

- Eliminate deduction for state and local taxes.
- Allow individuals and employers to contribute up to 20 percent of annual earnings to qualified retirement plans, up to $20,000 per year.
- Introduce an expanded refundable savings credit for taxpayers in the 15 percent tax bracket.
- Repeal the alternative minimum tax.
- Increase the excise tax on alcohol from about 21 cents per ounce to 25 cents.
- Phase in a 6.5 percent debt reduction sales tax over two years. The tax would be structured similarly to a broad-based value-added tax

DOMESTIC DISCRETIONARY AND DEFENSE SPENDING

The task force recommended that domestic discretionary spending be frozen for four years and defense spending be frozen for five years. After this time, spending growth would be allowed to increase at the rate of GDP growth. All spending limits would be enforced through statutory caps. If the caps were exceeded, automatic across-the-board spending cuts would occur. Cuts to domestic discretionary spending would save $1 trillion, and cuts to defense spending would save $1.1 trillion through 2020.

HEALTH CARE

The task force proposed short-term and long-term changes to all aspects of the health care system. As a whole, the reforms would save $756 billion through 2020.

Changes to Medicare

- Raise Part B premiums from 25 to 35 percent of program costs over five years.
- Use the government's bargaining power to increase rebates from pharmaceutical companies.
- Modernize benefits package and copayment structure.
- Bundle payments for post-acute care.
- Transition to a premium-support option to limit growth per beneficiary and increase competition among private plans.
- Eliminate barriers to enroll dual eligible patients (Medicare beneficiaries who are also eligible for Medicaid) in managed care.

Other Major Changes

- Reduce excess cost growth in Medicaid by 1 percentage point per year.
- Require states to cap awards for noneconomic and punitive damages for medical malpractice and test other reforms to the malpractice system.
- Impose an excise tax on sugar- and high fructose corn syrup–sweetened beverages.
- Reform the sustainable growth rate mechanism for physician payments.
- Cap the exclusion for employer-provided benefits in 2018 and phase out over 10 years. This would replace the "Cadillac tax" that is part of the Affordable Care Act.

How Could We Improve the Federal Tax System?

Debt Reduction Task Force, "Restoring America's Future," November 2010

SOCIAL SECURITY

The task force proposed several changes to Social Security to ensure its long-run sustainability. Major reforms include increasing the portion of wages subject to the payroll tax to 90 percent, changing the cost-of-living calculation, indexing the benefit formula for increases in life expectancy, reducing benefit growth for the top 25 percent of beneficiaries, and covering newly hired state and local government workers. To aid the most at-risk populations, the task force proposed an increase in the minimum benefit for long-term low-wage earners and the most vulnerable elderly.

OTHER SAVINGS

Cuts and reforms to smaller federal programs were projected to save $89 billion by 2020. The task force recommended that farm program spending be reduced by eliminating payments to producers with an adjusted gross income over $250,000, consolidating and capping conservation programs, and reforming crop insurance. In addition, they proposed changing the benefit calculation for civilian government retirees and changing the age at which career military personnel can retire.

BUDGET PROCESS

To enforce the proposed reforms, the task force recommended that changes to the budget-making system be enforced to increase accountability. Examples of reforms included statutory spending caps, a pay-as-you-go requirement to prevent a worsening of the fiscal situation, and a Fiscal Accountability Commission to meet every five years to evaluate program growth and other budget issues.

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Q. What is included in "The Tax Reform Act of 2014: Fixing Our Broken Tax Code So That It Works For American Families and Job Creators," proposed by the House Ways and Means Committee?

A. The Tax Reform Act of 2014 is an ambitious plan for broadening the tax base and simplifying both the corporate and personal income taxes, which was designed to be revenue-neutral over the 10-year budget horizon.

The Tax Reform Act of 2014 was proposed by former chairman of the House Ways and Means Committee Dave Camp to serve as a point of reference for tax reform. The Camp plan would reduce tax rates and eliminate or limit most tax expenditures. It would be revenue-neutral and income distribution–neutral over the 10-year budget horizon, but would lose revenue and become more regressive after the first decade.

INDIVIDUAL INCOME TAX

- Consolidate individual tax rates into three brackets: 10, 25, and 35 percent. The 35 percent bracket would be composed of the 25 percent rate plus a 10 percent surtax that only would apply to modified adjusted gross incomes over $450,000 ($400,000 for single taxpayers).
- Increase the standard deduction for all taxpayers and add an additional deduction for single taxpayers with at least one dependent child.
- Eliminate the personal exemption, state and local tax deduction, deduction for medical expenses, and other smaller tax expenditures.
- Over four years, reduce the cap on the interest deduction to mortgages of $500,000.
- Only allow deductions for charitable contributions in excess of 2 percent of adjusted gross income.
- Increase and expand the child tax credit.
- Modify the earned income tax credit, index the parameters to the chained consumer price index, and reduce eligibility for children to those younger than age 18. The earned income tax credit would thereby be reduced for almost all families.
- Consolidate higher education incentives into an American Opportunity Tax Credit.
- Modify the rules for individual retirement accounts (IRAs) and 401(k) plans by barring deductible contributions to traditional IRAs and removing income limits on contributions to Roth IRAs.
- Repeal the alternative minimum tax.
- Tax capital gains and dividends as ordinary income, with a 40 percent exclusion.

How Could We Improve the Federal Tax System?

The Tax Reform Act of 2014, House Ways and Means Committee

CORPORATE INCOME TAX

- Reduce the top corporate rate to 25 percent; phase in the reductions over five years.
- Shift to a territorial system (which would exempt the foreign income of US multinational firms from US taxation).
- Institute a retroactive tax on foreign earned income of 8.75 percent on cash assets and 3.5 percent on noncash assets. Payments could be spread over eight years, with all revenue allocated to the Highway Trust Fund.
- Institute a 0.035 percent excise tax on big banks that is levied quarterly on consolidated assets in excess of $500 billion.
- Repeal the corporate alternative minimum tax, along with the deduction for domestic production activities and most other business tax preferences.

ANALYSIS

The Joint Committee on Taxation predicts that the Camp plan would be revenue-neutral in the initial 10 years. However, when considering the macroeconomic effects, the committee found that the plan would potentially boost GDP by between 0.1 and 1.6 percent over the next 10 years, increasing federal revenue by between $50 billion and $700 billion.

Beyond the first 10 years, though, the fiscal impact would be uncertain. Many provisions that initially increased revenue would expire. In addition, the official estimates may have misstated the cost of making certain tax extenders permanent, thereby increasing the long-term cost of the plan. These additional costs may be partially offset by the adoption of the chained consumer price index for indexing tax rates, credits, and so on.

Tax burdens for heads of households would significantly increase in all quintiles of the income distribution except the lowest. It's also likely that households in high-tax states that now itemize their deductions, families with older children, and households that previously benefited from tax preferences that are now diminished or expired would bear a higher tax burden in the long run.

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Nunns, Jim, Amanda Eng, and Lydia Austin. 2014. "Description and Analysis of the Camp Tax Reform Plan." Washington, DC: Urban-Brookings Tax Policy Center.

Q. What is included in the Graetz "Competitive Tax Plan" 2015 update?

A. Graetz's proposal recommends cutting income and payroll taxes and making up the revenue with a value-added tax.

Columbia University law professor Michael Graetz introduced his "Competitive Tax Plan" more than a decade ago and has now updated it. Broadly, the plan shifts the tax system, which is based on income, to one based on consumption. The plan is revenue-neutral and would not change the overall distribution of income. It contains five components.

- A value-added tax (also called a goods and services tax) with a broad base and a single rate of 12.9 percent. Businesses with less than $1 million in gross receipts would be exempt. There would be an 18- to 24-month period between enactment and implementation, which Graetz expects would accelerate purchases of durable goods and provide a short-term boost to the economy. The tax would be modeled after modern value-added taxes in New Zealand, Australia, Canada, Singapore, and South Africa. States would be given incentives to harmonize their tax policies with the federal tax.
- An individual income tax in which the first $100,000 of income for married couples would be exempt from taxation ($50,000 for singles and $75,000 for heads of household). Above this threshold, tax rates would be 14, 27, and 31 percent. The alternative minimum tax and surtax on investment income would be repealed. With these reforms, less than one-fifth of the households now paying income tax would be required to file returns.
- A corporate income tax with a reduced tax rate of 15 percent. All credits except the foreign tax credit would be eliminated, and the corporate alternative minimum tax would be repealed. The plan may also subject large businesses (even if they are not corporations) to the corporate income tax, while simplifying the taxation of small businesses.
- The current payroll tax, but with payroll tax credits of 15.3 percent wages for workers with earnings up to $10,000 and a credit of $1,530 for workers earning between $10,000 and $40,000. The credit phases out for incomes above $40,000.
- Refundable child credits would be established and distributed through debit cards. Each child would qualify for $1,500 per year, with a phase-out provision for higher-income earners. Low- and moderate-income earners, on the other hand, would receive an additional rebate of up to $3,500 for one child and $5,200 for two or more children.

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Toder, Eric, Jim Nunns, and Joseph Rosenberg. 2012. *Using a VAT to Reform the Income Tax*. Washington, DC: Urban-Brookings Tax Policy Center.

Q. What is return-free tax filing and how would it work?

A. If an income tax system were simple enough, the government could withhold taxes owed and do its own accounting at the end of the year without much help from taxpayers.

EXACT-WITHHOLDING SYSTEM

In this variation, the tax agency attempts 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.

Two types of exact-withholding systems exist. Cumulative systems (used in the United Kingdom and Russia) aim to withhold exactly the right amount of tax at regular intervals across the year; final-withholding systems (used in Germany and Japan) make adjustments by withholding more or less money from the final paycheck of the tax year.

TAX AGENCY RECONCILIATION SYSTEM

In a tax agency reconciliation system, taxpayers choosing the option provide basic information to the tax authority. The tax authority then calculates 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 correct) these calculations and submits the return.

TAX AGENCY RECONCILIATION VERSUS EXACT WITHHOLDING

In both variations, taxpayers must report certain nonfinancial information to either their employers or the tax authority. In the United States, this would likely consist of the taxpayer's name, address, Social Security number, and filing status, along with the names and Social Security numbers of spouses and dependents. The employer or the tax authority would use this information to calculate withholding allowances. Taxpayers might be required to report this information on a periodic basis, or whenever there is a change in their circumstances that would affect tax liability.

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.

How Could We Improve the Federal Tax System?

What is return-free tax filing and how would it work?

RETURN-FREE ELIGIBILITY

A return-free system in the United States could include more taxpayers if the tax code were adjusted in several important ways:

- having the vast majority of taxpayers face the same marginal ("basic") tax rate;
- making the unit of taxation the individual rather than the family;
- taxing interest and dividend income at a flat rate, and withholding it at the source;
- largely exempting capital gains from taxation; and
- limiting the number of itemized deductions.

None of these conditions, however, are necessary to operate a return-free system for at least some taxpayers.

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Q. What are the benefits of return-free tax filing?

A. It eases the burden of tax compliance on individuals, and has the potential to make the tax code simpler and tax collection and enforcement more efficient.

The primary benefit of a return-free system is a reduced tax compliance burden. Depending on the extent of changes made to the current US income tax structure and administration to accommodate return-free filing, the requirement to file a final tax return could be eliminated for somewhere between 8 million and 60 million households. Secondary benefits include simplification of the tax code, that could accompany such a reform, and perhaps a lower administrative burden on the Internal Revenue Service and lower federal expenditure for tax collection.

Filing tax returns can be a drain on taxpayers' time, emotions, and, for those who hire a tax preparer, wallets. Thus, even if most affected taxpayers can complete their returns with relatively little effort, a return-free system could still provide them significant benefits. There is one important catch: because state income tax systems piggyback on the federal system, if the states failed to shift to a return-free system, the reduction in costs would be modest.

Although taxpayers participating in the return-free system would be spared filing paperwork, the net administrative savings might not be great. Of the 62 million or so taxpayers potentially eligible, over two-thirds currently file the relatively simple 1040A and 1040EZ returns. Even under a return-free system, these taxpayers would still have to provide 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 1996, the US 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 costs by up to $37 million annually. These estimates, however, do not take into account the 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 later). State income tax authorities would also incur additional costs or delays.

How Could We Improve the Federal Tax System?

What are the benefits of return-free tax filing?

Further Reading

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Q. What are the drawbacks of return-free tax filing?

A. Potential drawbacks include a heavier administrative burden for those charged with withholding income tax and for government collection agencies, as well as added limits on taxpayer independence.

Drawbacks to a return-free system include a 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 allow the government to decide how much tax was owed, limiting taxpayer independence and constraining taxpayers' ability to appeal tax decisions by tax agencies.

Taxpayers appear to like overpaying tax through withholding, and then 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 would still be possible.

Some argue it is important to have a "visible" tax system (as we do now) on the principle that citizens who know what they pay can make better economic and political choices. In a return-free system, taxpayers would presumably be less informed about how they are being taxed and thus 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 IRS 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 US General Accounting Office in 1996 agreed that significant investments in IRS processing capabilities would likely be needed to implement such a system.

How Could We Improve the Federal Tax System?

What are the drawbacks of return-free tax filing?

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Q. How would the tax system need to change with return-free tax filing?

A. The simpler the system, the easier it would be to increase the number of return-free filers.

Although many countries have adopted return-free tax systems, most of them have simpler tax codes than the United States. Implementing a return-free system that most US taxpayers could participate in would require sweeping changes in the tax code to make it more similar to those of countries that already use return-free filing. Common elements of such codes include a "basic" rate for most taxpayers, the designation of individuals (rather than families) as the unit of taxation, taxation of interest and dividend at one rate (and at the source), exemption of some capital gains from taxation, and the paring of deductions, allowances, and credits.

Still, with just minor reforms, the current system could still accommodate return-free filing for the substantial number of taxpayers who now file relatively simple returns. A big stumbling block is that 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. Indeed, 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 any changes in the law, it might still be possible to fine-tune withholding formulas to meet the needs of most taxpayers. But there's no free lunch here: attaining the additional precision would add significant complexity to Form W-4 and the computation of withholding allowances.

Further Reading

Gale, William G., and Janet Holtzblatt. 1997. "On the Possibility of a No-Return Tax System." *National Tax Journal* 50 (3): 475–85.

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Q. Who would qualify for return-free tax filing?

A. As many as 50 million taxpayers would qualify, including most of those who take the standard deduction and rely on wages for most of their income.

The size and scope of a return-free system would depend on its administrative and structural features. At best, some 50 million would qualify. This group would mostly consist of earners whose incomes come from wages and who choose not to itemize their deductions. The system could be expanded to include taxpayers with income from dividends, interest, pensions, individual retirement account distributions, and unemployment insurance benefits, as well as low-income earners qualifying for the earned income tax credit (EITC). Taxpayers with relatively uncomplicated itemized deductions could also be brought into the system.

In 2003, the Treasury conducted a study on how return-free filing system could be implemented; the report was later updated to reflect 2007 tax data. Tables 1 and 2 break down the numbers.

TABLE 1

Filers Qualifying for Alternative Return-Free Systems

By type of income, 2007

Filing system	Type of filer by change in administrative practice	Total (millions)	Percentage of current law filers
Current law	Total filers	138.8	100.0
Exact withholding	With current withholding rules[a]	8.2	5.9
	Plus more precise withholding rules[b]	19.9	14.3
	Plus expanded mandatory withholding[c]	30.9	22.2
	Plus delivering EITC through means other than tax return	43.5	31.3
Agency reconciliation	Plus exempting two-earner couples from filing	46.7	33.6
	Plus exempting taxpayers in higher brackets from filing	50.0	36.0

Source: Holtzblatt, 2007.

(a) This category is limited to taxpayers whose income is derived solely from one job and who do not claim above-the-line or itemized deductions or credits other than the child tax credit. Dependent filers are excluded. The exact withholding system is assumed to be restricted to taxpayers in the 15% or lower rate brackets.

(b) The withholding rules would be made more precise, so that the correct amount of taxes could be collected from filers who are claimed as dependents by other taxpayers or who have more than one job. However, two-earner couples are excluded from this category.

(c) Mandatory withholding would be extended to income from pensions and individual retirement account distributions, unemployment compensation, interest and dividends.

How Could We Improve the Federal Tax System?

Who would qualify for return-free tax filing?

TABLE 2

Filers Qualifying for Alternative Return-Free Systems

By type of return under current law, 2007

Filing system	1040 (millions)	Percent of total	1040A (millions)	Percent of total	1040EZ (millions)	Percent of total	Total
Current law	87.1	62.8	30.0	21.6	21.7	15.6	138.8
Exact withholding	6.0	13.8	18.7	43.0	18.8	43.2	43.5
Agency reconciliation	7.5	15.0	21.4	42.9	21.0	42.0	50.0

Source: Holtzblatt, 2007.
Note: Amount may not add up to total because of rounding.

ELIGIBILITY

The Treasury reports that 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 the source were extended to interest, dividends, pensions, individual retirement account distributions, and unemployment insurance benefits, the number 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 may also add to taxpayers' administrative burdens. To reduce these burdens, 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 withholding.

THE EARNED INCOME TAX CREDIT

Administering the EITC under an exact-withholding system would be complex but feasible. Under a tax agency reconciliation system, the EITC could continue to be administered through the tax system. With the EITC included in the return-free model, an additional 13.5 million taxpayers would have been eligible for a return-free system in 1999.

ITEMIZED DEDUCTIONS

Some deductions could be accommodated within a return-free system. Three of the most common are for state and local taxes, mortgage interest, and charitable contributions. The Treasury predicts that 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. But these numbers represent a modest fraction of the current 33 million itemizers, demonstrating that itemizers do not generally meet other restrictions needed to avoid filing.

How Could We Improve the Federal Tax System?

Who would qualify for return-free tax filing?

Further Reading

Gale, William G., and Janet Holtzblatt. 1997. "On the Possibility of a No-Return Tax System." *National Tax Journal* 50 (3): 475–85.

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US Department of the Treasury. 2003. *Return-Free Tax Systems: Tax Simplification Is a Prerequisite*. Washington, DC: US Department of the Treasury.

Q. Would return-free tax filing raise taxes?

A. Not for those who pay what they owe now.

While some anti-tax groups have suggested otherwise, a return-free system would not raise taxes for households already paying all the taxes they owe. Nor would anyone need to share more information with the IRS than they do now.

Some Congressional conservatives, along with some anti-tax groups including Americans for Tax Reform and the American Conservative Union, oppose return-free filing on the grounds that it would shift the burden of contesting tax liability from the IRS to the taxpayer. They have other concerns, too. Americans for Tax Reform argues that implementing return-free filing would be 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.

These seem weak objections. 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 would 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.

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Q. What was the experience of California with return-free tax filing?

A. Generally positive

California operated a pilot program for return-free tax filing in tax years 2005 and 2006. Some 50,000 pre-screened Californians who had previously filed as single taxpayers with no dependents, no itemized deduction, and wage income only were invited to participate. These taxpayers were sent "ReadyReturns"—completed forms—and were given the option of either filing their ReadyReturns (on paper or online) or discarding them and filing conventional returns later. The pilot program was popular among taxpayers who used it, and California subsequently authorized the widespread availability of ReadyReturn for tax year 2007. The program has now been incorporated into CalFile, the state's free online tax filing site.

PROGRAM PARTICIPATION

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, the state's tax administrator, reported that over 88,000 people used the service in 2012. The board estimated that about 2 million taxpayers would be eligible for the ReadyReturn in 2013, indicating that the program could be expanded relatively easily to much of the state's population.

THE PROGRAM'S SUCCESS

Reviews of the system have been positive. Of those filing an electronic ReadyReturn, 95 percent said that it saved time, as did 87 percent of participants filing a paper version. Almost all participants said that they would opt to use the service the following year. Tax preparation services strongly opposed ReadyReturn and have lobbied against its expansion.

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Q. What other countries use return-free tax filing?

A. At last count, 36 countries, including Germany, Japan, and the United Kingdom, permit return-free filing for some 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 Russia) and "final-withholding" systems (used in Germany and Japan). Some countries combine one of these approaches with other requirements; in Chile, for example, taxpayers are not eligible if they wish to file for refunds of excess withholdings.

COUNTRIES WITH TAX AGENCY RECONCILIATION SYSTEMS

Denmark and Sweden, both relatively small countries, operate tax agency reconciliation systems. About 87 percent of Denmark's taxpayers and 74 percent of Sweden's had their returns filled out by the tax authorities in 1999. Spain, Estonia, Finland, Norway, and Iceland have also implemented tax agency reconciliation systems.

THE BRITISH EXPERIENCE

Britain's Pay As You Earn (PAYE) system, which has incorporated exact withholding since the 1940s, has several features that facilitate return-free filing. One is that it treats the individual (rather than the family) as the unit of taxation. Another is that a large proportion of taxpayers (64 percent) are taxed at the same "basic" marginal rate. The system was reformed in April 2013 to require employers to report salary payments in real time, with the goal of decreasing withholding errors. The reform also linked revenue collection and benefit payments to the same database for purposes of increasing efficiency.

Despite the clear need for the changes, concern still exists as to whether real-time reporting places a disproportionate burden on small businesses. To minimize the problem, small employers have been temporarily allowed to file payments on a monthly basis. In 2014, about 90 percent of the United Kingdom's income tax revenue was collected through PAYE.

FILING RATES

The portion of taxpayers who still have to file returns varies widely by country. About 90 percent of taxpayers eligible for final withholding in the United Kingdom did not have to file in 2014. The figures for other countries are dated, but there's no reason to believe that they are unrepresentative. In Germany in 1986 and in Japan in 1988–90, the corresponding figures were 46 percent and 63 percent, respectively.

How Could We Improve the Federal Tax System?

What other countries use return-free tax filing?

Many countries, it should be noted, maintain a filing requirement for taxpayers with more than one job. At least one, Kenya, requires taxpayers to file a return if their personal circumstances change during the year.

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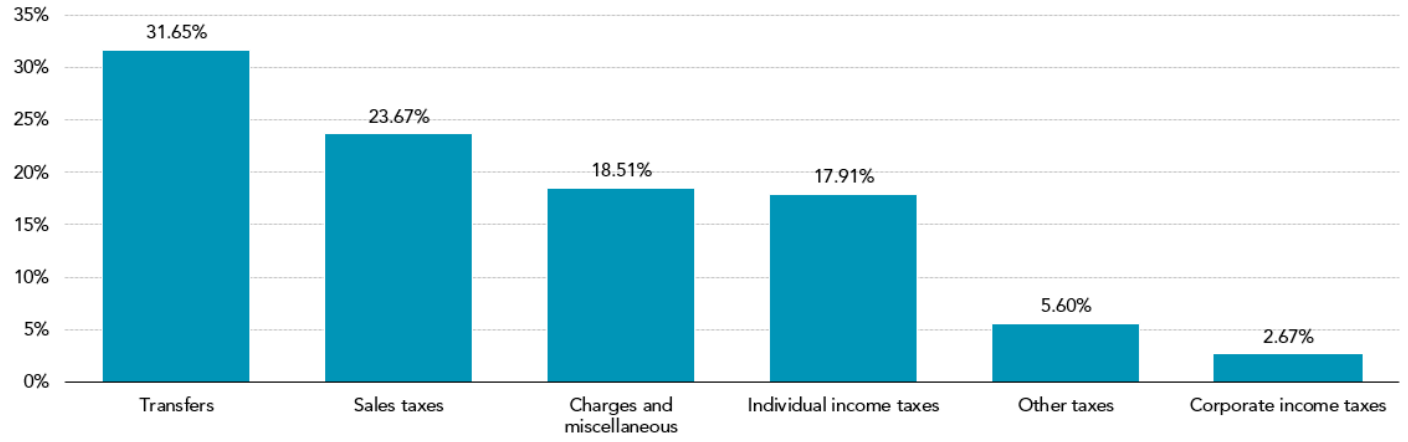
The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

Q. What are the sources of revenue for state governments?

A. State governments collected more than $1.7 trillion of general revenue in 2014. Revenue from income, sales, and other taxes totaled nearly $870 billion—half of all general revenue (figure 1).

FIGURE 1
Total State General Revenue by Source
2014



Sources: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

INTERGOVERNMENTAL TRANSFERS

Intergovernmental transfers—primarily from the federal government—totaled $551 billion in 2014. The largest were federal grants for public welfare programs, predominately for Medicaid.

The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

OWN-SOURCE REVENUE

Revenue from state sales and gross receipts taxes (including taxes on general purchases and selective taxes on products such as alcohol, cigarettes, and motor fuels) was $412 billion in 2014, or 24 percent of state general revenue. Revenue from individual income taxes totaled $312 billion—18 percent of general revenue—while revenue from other taxes (including license fees, estate taxes, and severance taxes) was $97 billion—6 percent of general revenue. Charges and fees—notably tuition paid to state universities, payments to public hospitals, and tolls on highways or bridges—provided another $322 billion, —19 percent of state general revenue in 2014.

General revenue does not include revenue collected by states from "business-like" enterprises, such as state-run liquor stores, utilities, and pension funds.

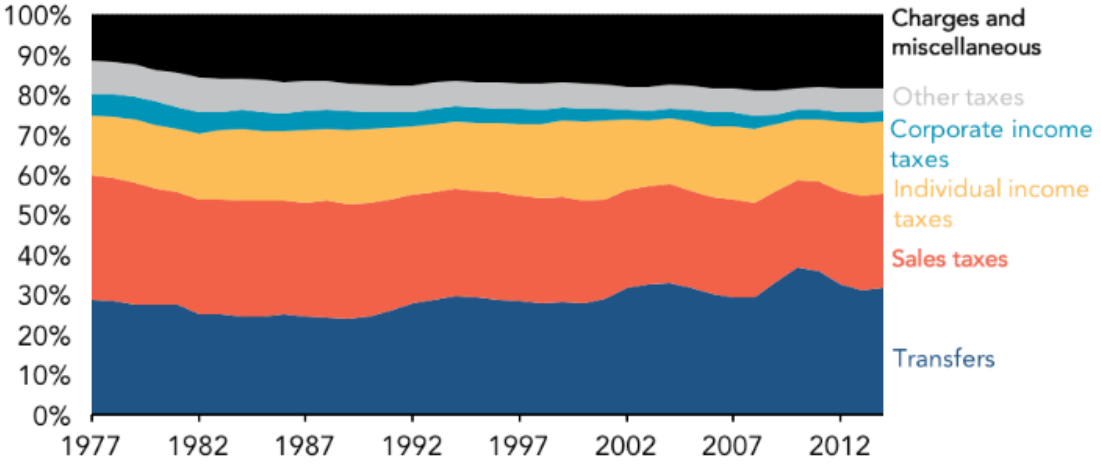
CHANGING SOURCES

Since 1977, the shares of state general revenue from intergovernmental transfers as well as charges and users fee have increased, while the share from taxes has declined (figure 2). The change in the charges and user fee category was especially striking, with its share rising by 8 percentage points (from 11 percent to 19 percent) from 1977 to 2014, as states sought to broaden their revenue bases.

Over the same period, the share of general revenue from state taxes declined by 10 percentage points, from 60 percent to 50 percent. The portion from individual income taxes rose slightly over the period, while the share from all other taxes declined.

FIGURE 2

State General Revenue, 1977-2014



Source: Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

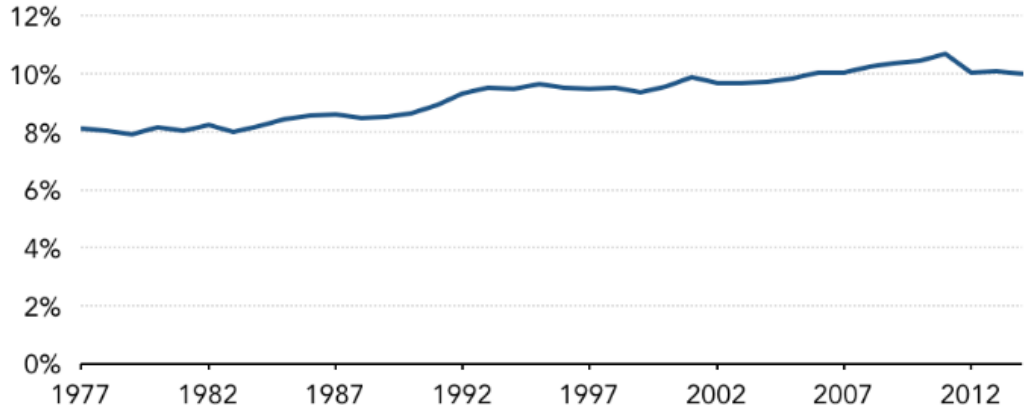
RELATIVE GROWTH

State revenue grew slightly faster than the national economy between 1977 and 2014, rising from 8 percent of GDP in 1977 to 10 percent in 2005 and staying there for the next decade (figure 3). State revenues peaked at 11 percent of GDP in 2011 before falling back to 10 percent in 2014, largely because of a decline in federal transfers in the wake of the economic recovery.

FIGURE 3

Total State General Revenue, 1977-2014

As a share of national GDP



Source: BEA; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

Revenue from charges and miscellaneous fees as well as individual income taxes grew a small amount relative to GDP from 1977 to 2014, while sales tax revenue remained fairly constant at about 2.5 percent of GDP (figure 4). Intergovernmental transfers grew the most over that period, rising about 1 percent of GDP. The American Recovery Reinvestment Act of 2009 created a sharp uptick in federal transfers to state governments from 2009 to 2011, hitting a peak of 3.8 percent of GDP in 2010 and 2011. Federal transfers to the states dropped as a share of GDP in 2012 as spending on economic stimulus programs receded.

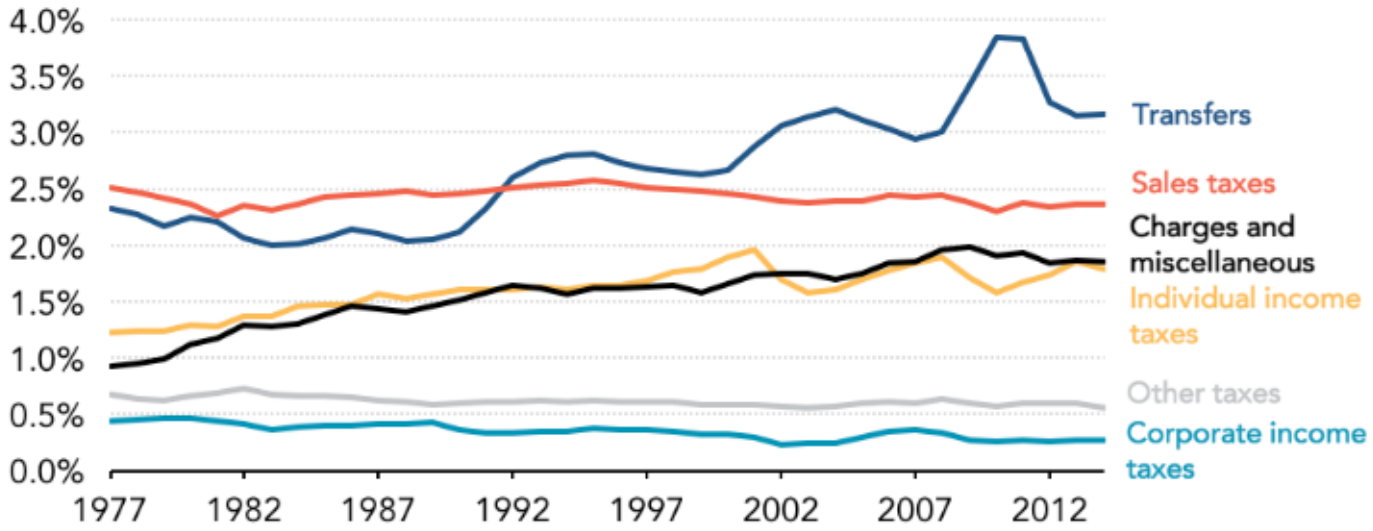
The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

FIGURE 4

State General Revenue by Source, 1977-2013

As a share of national GDP



Source: BEA; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

Data Sources

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Tax Policy Center. State and Local Finance Data Query System. Urban Institute and Brookings Institution, Washington, D.C.

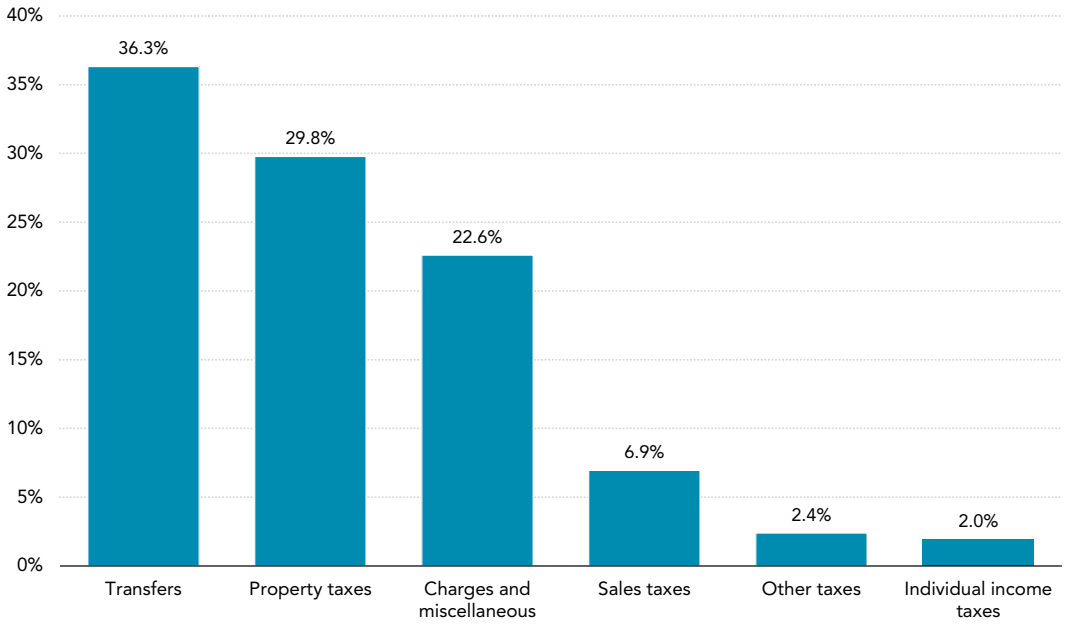
Further Reading

Brunori, David. 2005. *State Tax Policy: A Political Perspective*, 2nd ed. Washington, DC: Urban Institute Press.

Q. What are the sources of revenue for local governments?

A. Local governments collected more than $1.5 trillion of general revenue in 2014. Revenue from local property, sales, and other taxes totaled $624 billion, about 41 percent of general revenue (figure 1).

FIGURE 1
Local General Revenue by Source
2014



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

INTERGOVERNMENTAL TRANSFERS

Of the 36 percent of local government general revenue that were transfers from other levels of government, 32 percent came from state governments (including indirect federal funds), and 4 percent came directly from the federal government. Local governments include county governments, municipalities, townships, special districts (such as water and sewage authorities), and school districts. Aid to school districts account for more than half of all state government transfers to localities. Housing programs make up 40 percent of federal transfers to local governments.

The State of State (and Local) Tax Policy

What are the sources of revenue for local governments?

OWN-SOURCE REVENUE

Revenue from property taxes was $452 billion in 2014—30 percent of local government general revenue and the largest single source of tax revenue (figure 1). Revenue from sales taxes was $105 billion—7 percent of general revenue. Revenue from individual income taxes was $30 billion—another 2 percent—while revenue from other taxes (such as stadium taxes and business license taxes) was $36 billion— just over 2 percent. Charges and miscellaneous fees, such as water, sewerage, and parking meter fees collected by municipal or county governments, provided $343 billion or 23 percent of general revenue.

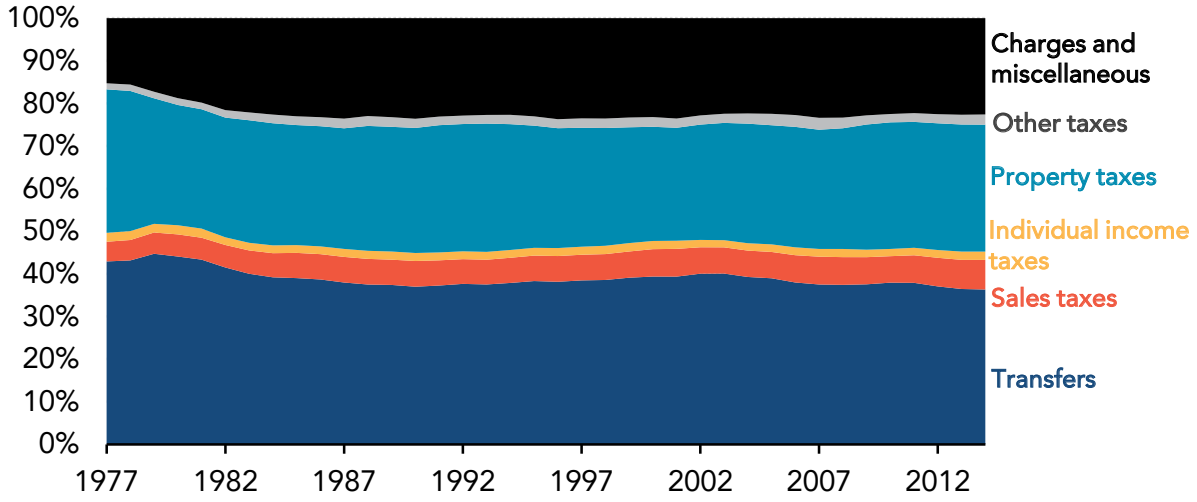
CHANGING SOURCES

Since 1977, the share of local government revenue from nontax sources has remained fairly steady at 60 percent of general revenue. However, the composition of non-tax revenue has changed. The portion from intergovernmental transfers declined from 43 percent of general revenue in 1977 to 36 percent in 2014, while revenue from charges and fees increased from 15 percent to 23 percent.

Likewise, while the share of general revenue from local taxes has remained at about 40 percent, the composition of tax revenue changed. The contribution of property taxes to general revenue declined from 34 percent in 1977 to 30 percent in 2014, while revenue from sales taxes increased from 5 percent to 7 percent.

FIGURE 2

Local General Revenue by Source, 1977-2014



Source: Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

REVENUE GROWTH COMPARED WITH ECONOMIC GROWTH

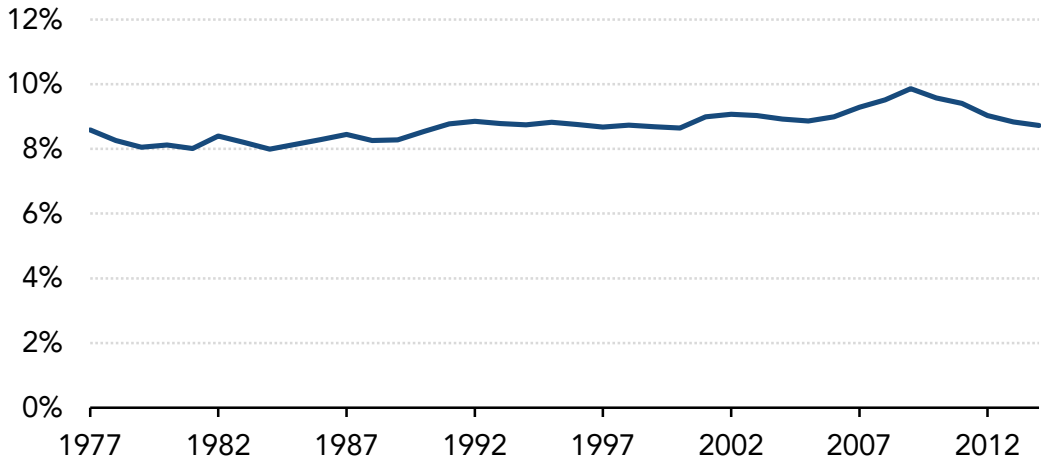
Although local government revenue was about the same relative to GDP in 2012 as it was in 1977, there were fluctuations over that period (figure 3). The figure fell to a low of 8.0 percent in 1980 and peaked at 9.9 percent in 2009.

The State of State (and Local) Tax Policy

What are the sources of revenue for local governments?

FIGURE 3

Total Local General Revenue, 1977-
As a share of national GDP



Source: Bureau of Economic Analysis; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

Much of the change in local government revenue relative to the economy was because of fluctuations in transfers provided by the federal and state governments. Transfers fell from 1977 through most of the 1980s and increased slowly though the 1990s. This source of revenue is cyclical; it grew sharply during the 2001 and the 2007–09 recessions, receding in both cases as the economy recovered (figure 4).

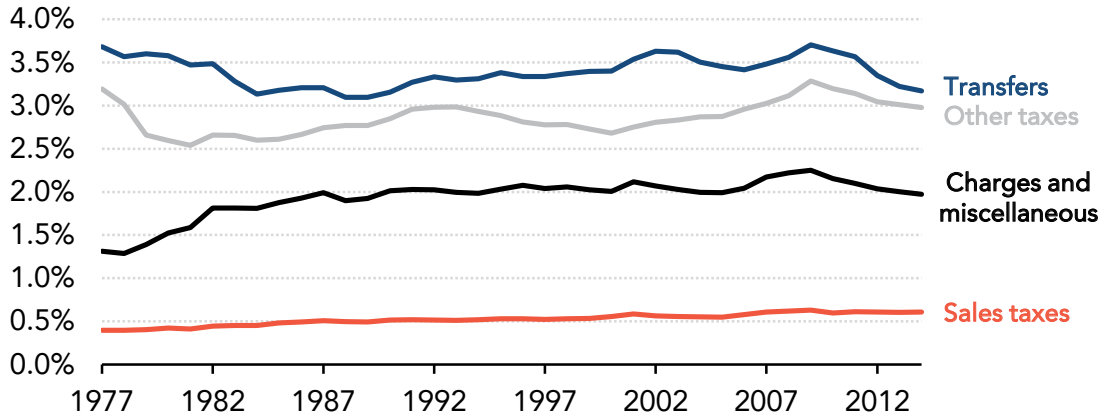
The State of State (and Local) Tax Policy

What are the sources of revenue for local governments?

FIGURE 4

Local General Revenue by

As a share of national GDP



Source: Bureau of Economic Analysis; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.
Note: Other includes revenue from the individual income tax, property taxes, and other local taxes.

Data Sources

US Department of Commerce, Bureau of Economic Analysis. BEA National Economic Accounts: Current-dollar and 'real' GDP.

Tax Policy Center. State and Local Finance Data Query System. Urban Institute and Brookings Institution, Washington, D.C.

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Q. How do state and local individual income taxes work?

Forty-one states and the District of Columbia levy broad-based taxes on individual income. New Hampshire and Tennessee tax only individual income from dividends and interest. Seven states do not tax individual income of any kind. Local governments in 12 states levy their own income tax on top of state taxes.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS COLLECT FROM INDIVIDUAL INCOME TAXES?

State governments collected $312 billion—26 percent of state own-source general revenue—from individual income taxes in 2014 (table 1). "Own-source" revenue excludes intergovernmental transfers. By contrast, local governments, concentrated in Maryland, New York, Ohio, and Pennsylvania, collected just $30 billion—3 percent of revenue.

TABLE 1

State and Local Individual Income Tax Revenue
2014

	Revenue (billions)	Percentage of own-source general revenue
State and local	341	16
State	312	26
Local	30	3

Source: State & Local Government Finance Data Query System. The Urban Institute-Brookings Institution Tax Policy Center.

Note: Own source general revenue does not include intergovernmental transfers.

Forty-one states and DC levy a broad-based individual income tax. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have a state individual income tax. Maryland relied most on the tax, collecting 29 percent of combined state and local own-source general revenue from it in 2013. Connecticut, Massachusetts, and Oregon each collected 25 percent of revenue from the tax.

Three states with a broad-based individual income tax collected less than 10 percent of total state and local own-source general revenue from that tax. North Dakota (8 percent of revenue) relied least on the tax. New Hampshire and Tennessee, with much more limited individual income taxes, collected about 1 percent of revenue from them.

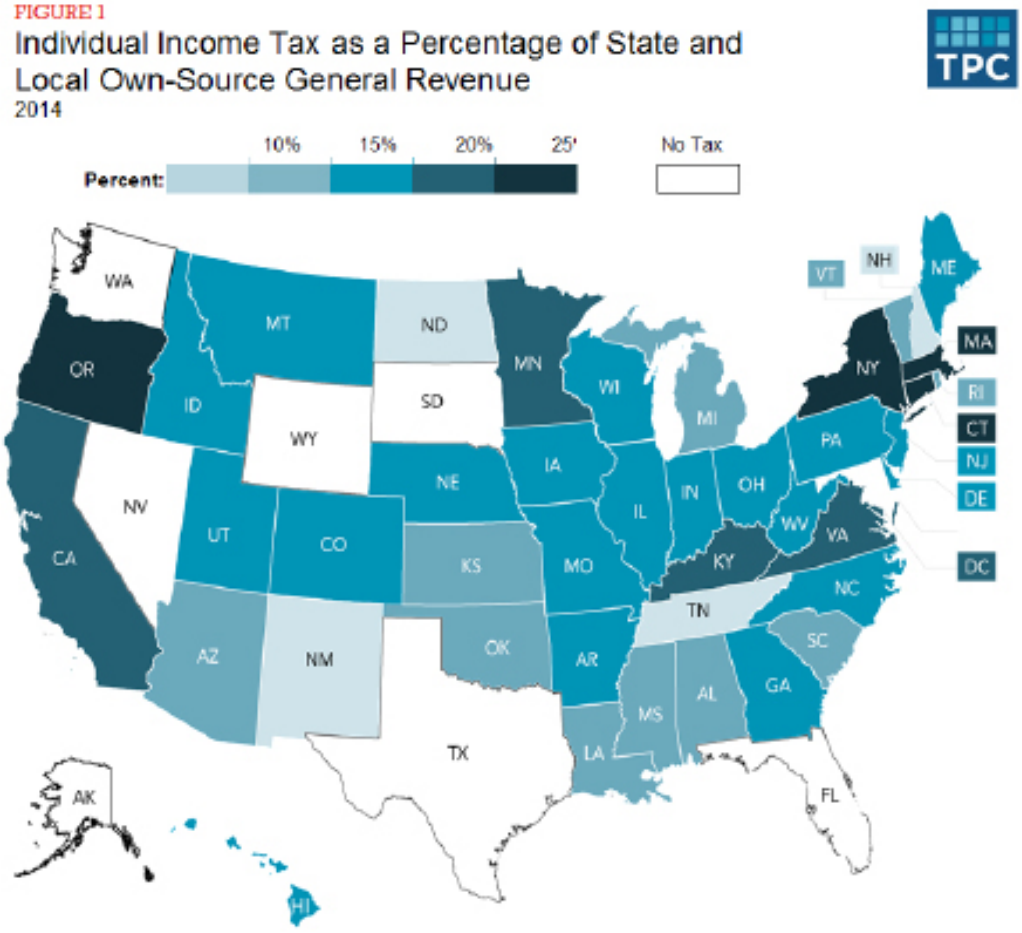
The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

FIGURE 1

Individual Income Tax as a Percentage of State and Local Own-Source General Revenue

2014



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

Note: Own source general revenue does not include intergovernmental transfers.

In 12 states local governments levied their own individual income taxes in 2013. DC also has its own individual income tax. Individual income taxes provided an average of 10 percent of local own-source general revenue in those states and DC, ranging from 1 percent in Alabama and Iowa to 21 percent in DC and 25 percent in Maryland.

WHAT INCOME IS TAXED?

Most states follow the federal definition of taxable income, but there are exceptions. New Hampshire and Tennessee tax only dividends and interest. States, however, often apply different rules than the federal government for certain types of income. Unlike the federal government, states often tax municipal bond interest from securities issued outside that state, and many allow a full or partial exemption for pension income. Recently, Kansas and Ohio exempted some or all sole proprietor income and partnership income. In many states, taxpayers who itemize their federal tax deductions and claim deductions for state and local taxes may not deduct those taxes on their state income tax returns.

The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

HOW DO INDIVIDUAL INCOME TAX RATES VARY ACROSS STATES?

Most state income taxes are fairly flat, even in those states that apply graduated rates. Eight states impose a single tax rate on all income, while Missouri has the most with 10 tax brackets. Top marginal rates for state income tax in 2016 ranged from 3.07 percent in Pennsylvania to 13.3 percent in California—including a 1 percent surcharge on incomes over $1 million in that state (figure 2). In states with multiple tax brackets, the top tax bracket often begins at a very low level of taxable income. Alabama, for example, has three rates, but the top tax bracket starts at taxable income of $3,000, making it essentially a flat tax. In other states, the difference between the lowest and the highest tax rates is small: about 2 percentage points in Kansas and Mississippi, for example.

While most states followed the federal government's lead in reducing the number of income tax brackets in the 1980s, there has been a lot of regression. California and New York have imposed new brackets (often called "millionaire's taxes") for high-income taxpayers. California approved a millionaire's tax in 2013 that adds 1 percentage point to the rate applied to incomes over $1 million. Similarly, New York's top tax rate of 8.82 percent applies to income above about $1 million.

California, Minnesota, and Oregon have top rates above 9 percent. Iowa, New Jersey, New York, Vermont, and DC have top income tax rates above 8.8 percent.

HOW DO STATES TAX CAPITAL GAINS AND LOSSES?

Eleven states and DC treat capital gains and losses the same as under federal law. They tax all realized capital gains, allow a deduction of up to $3,000 for net capital losses, and permit taxpayers to carry over unused capital losses to subsequent years. However, most states tax capital gains at the same rate as ordinary income, while the federal government provides a preferential rate. New Hampshire fully exempts capital gains, and Tennessee taxes only capital gains from the sale of mutual fund shares. Arizona exempts 25 percent of long-term capital gains, and New Mexico exempts 50 percent. Massachusetts has its own system for taxing capital gains, while Hawaii has an alternative capital gains tax. Pennsylvania and Alabama only allow losses to be deducted in the year that they are incurred, while New Jersey does not allow losses to be deducted from ordinary income. The remaining 25 states that tax income generally follow the federal treatment of capital gains, with the exception of various state-specific exclusions and deductions.

HOW DO STATES TAX INCOME EARNED IN OTHER JURISDICTIONS?

Income tax is generally imposed by the state in which the income is earned. Some states, however, have entered into reciprocity agreements with other states that allow outside income to be taxed in the state of residence. For example, Maryland's reciprocity agreement with DC allows Maryland to tax income earned in the District by a Maryland resident. As of 2010, 15 states and DC had adopted reciprocity agreements. Typically, these are states with major employers close to the border and large commuter flows in both directions.

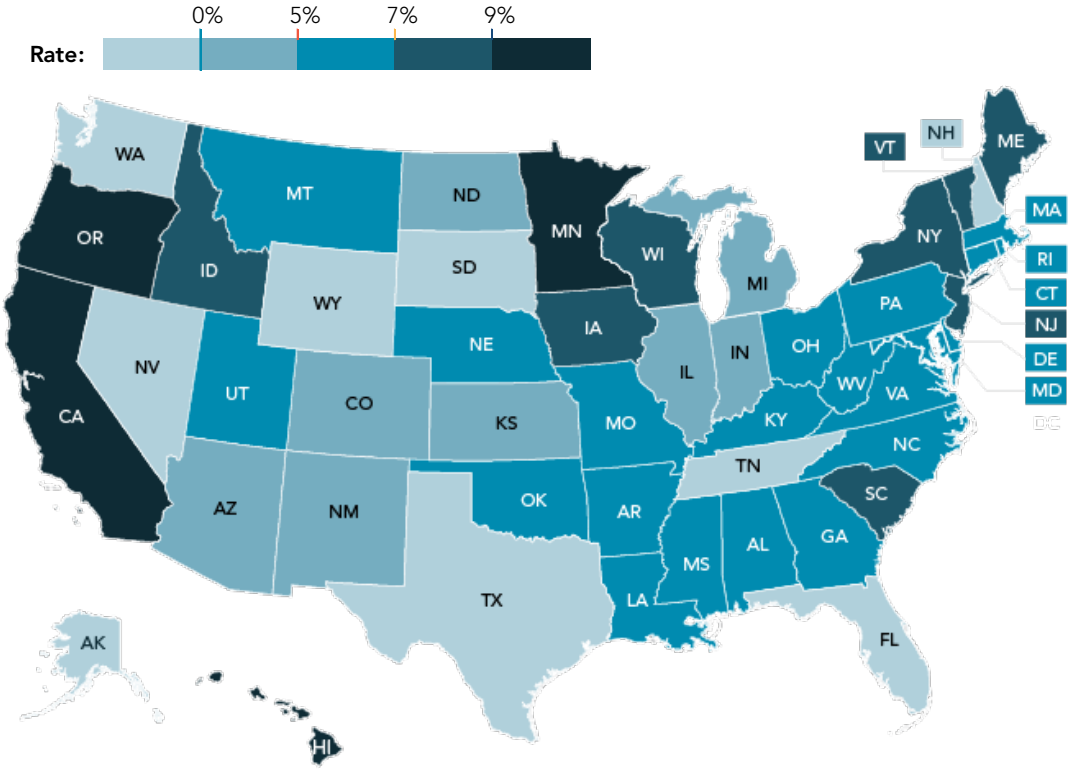
The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

FIGURE 2

Top State Individual Income Tax Rates

2015



Source: Federation of Tax Administrators.

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Q. How do state and local sales taxes work?

A. Forty-five states and the District of Columbia levy general sales taxes that apply (with some exemptions) to all goods and certain services. Thirty-eight states (including, Alaska, which has no state sales tax) also allow sales tax at the local level. Most states apply separate sales taxes to particular goods, typically tobacco, alcohol, and motor fuels.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM SALES TAXES?

States rely on sales taxes more than local governments do. States collected $412 billion—35 percent of own-source general revenue—from sales taxes in 2014 (figure 1). "Own-source" revenue excludes intergovernmental transfers. Nearly two-thirds of that ($272 billion) came from general sales taxes, and one-third ($140 billion) came from selective sales taxes (excise taxes) on tobacco, alcohol, and the like. Local governments, for their part, collected $105 billion—11 percent of local government own-source general revenue—from sales taxes in 2014, with $75 billion coming from general sales taxes and $30 billion from selective sales taxes.

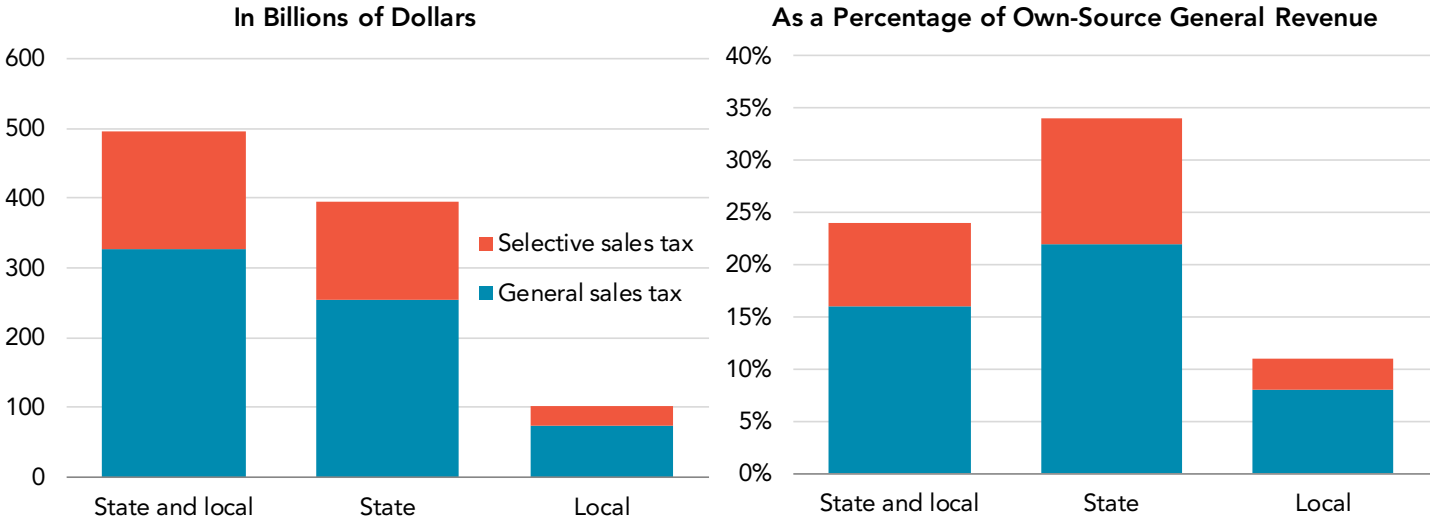
Nevada relied on sales tax revenue more than any other state in 2014, with sales and selective sales taxes accounting for 44 percent of combined state and local own-source general revenue. Sales and selective sales taxes represented more than 35 percent of combined state and local revenue in Arkansas, Hawaii, South Dakota, Tennessee, and Washington in 2014, and more than 30 percent in Arizona, Florida, Louisiana, and Texas. Among the states with a general sales tax, Massachusetts (15 percent of revenue) relied least on sales and selective sales tax revenue.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?

FIGURE 1

State and Local Sales Tax Revenue
2013



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.
Note: Own source general revenue does not include intergovernmental transfers.

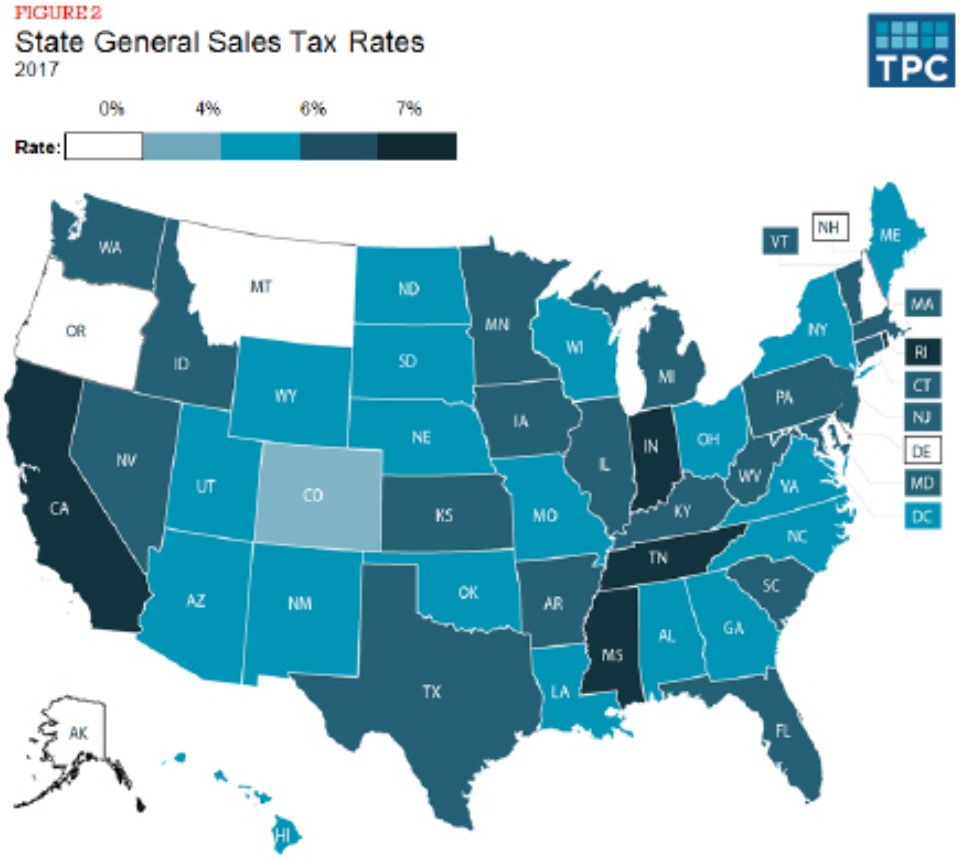
Every state and DC collected some revenue from selective sales taxes, with average revenue from such taxes accounting for 8 percent of state and local own-source general revenue. Sixteen states collected 10 percent or more of combined state and local revenue from selective sales taxes. Nevada had the highest revenue share from selective sales taxes—17 percent, while Alaska and Wyoming collected the least, around 3 percent of revenues, from selective sales taxes. combined state and local revenue from excise taxes. Nevada had the highest revenue share from excise taxes—16 percent, while Alaska and Wyoming each collected less than 3 percent of revenues from excises.

HOW DO GENERAL SALES TAX RATES DIFFER ACROSS STATES?

Among states with general sales taxes, Colorado has the lowest rate (2.9 percent) (figure 2). No other state with a general sales tax has a rate below 4.0 percent. Six states have rates at or above 7.0 percent. California has the highest rate (7.7 percent). Alaska, Delaware, Montana, New Hampshire, and Oregon have no state general sales taxes.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?



Source: Federation of Tax Administrators

Thirty-eight states (including Alaska, which has no statewide tax) allow local governments to impose their own general sales taxes. The maximum sales tax rates levied by local governments range from 0.5 percent in Hawaii to 8 percent in Colorado.

WHAT PURCHASES ARE SUBJECT TO THE GENERAL SALES TAX?

General sales taxes typically apply to most tangible goods. One notable exception is food purchased for use at home: only 13 states tax such purchases, and six of these states tax food at a lower rate than their general rate. Five of the 13 states that tax food for home consumption provide income tax credits to low-income residents to help offset the tax. In contrast, food bought for immediate consumption at restaurants is taxed, often at a higher rate than the general sales tax rate.

Many states also exempt nonprescription drugs, textbooks, and clothing from general sales taxes. Some states have sales tax holidays, periods in which specific purchases—for example, clothes and school supplies right before the start of a new school year—are sold tax-free.

The taxation of services (e.g., dry cleaning, carpentry work, barbershops) is more complicated. All states tax some services, but exemptions are common. Very few states tax professional services such as doctors and lawyers. Hawaii and New Mexico are exceptions to that rule, taxing nearly all services.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?

DO SALES TAXES APPLY TO ONLINE PURCHASES?

The treatment of online and other remote sales (e.g., catalog sales) is complex. Under the commerce clause of the US Constitution, if a retailer has no physical presence in the online purchaser's state of residence (technically called a "nexus" requirement) the state cannot require the retailer to collect a state or local sales tax from the consumer.

Many consumers do not realize, however, that in addition to sales taxes, states also levy use taxes. Consumers are subject to these taxes on goods purchased outside their states of residence for consumption in their home states. The use tax rate is the same as the sales tax rate, but few consumers actually pay it. Most states with both a sales tax and an individual income tax (such as California, Kentucky, Virginia, and Utah) give taxpayers a chance to declare liability and pay use taxes on their income tax returns.

The Supreme Court (*Quill Corp. v North Dakota*) ruled that states cannot require remote sellers to collect sales taxes, but that Congress could enact new rules. The Marketplace Fairness Act, first introduced in Congress in 2011, would allow states to require remote sellers to collect sales taxes on online purchases by their residents. The act would require that states simplify their sales taxes to make it easier for out-of-state sellers to collect the tax. It would also exempt sellers with less than $1 million of sales from the obligation. Congress has yet to pass the legislation.

WHAT TAXES DO STATES LEVY ON TOBACCO, ALCOHOL, AND MOTOR FUELS?

Most states levy "selective" sales taxes—with different rates than the general sales tax—on particular goods and services. Three of the best-known are taxes on cigarettes (and other tobacco products), alcohol, and motor fuels. Those products are also subject to a federal tax. For cigarettes and alcohol, the taxes are sometimes called "sin" taxes because one purpose of the tax is to discourage consumption.

Cigarette taxes are typically levied per pack. Missouri has the lowest rate (17 cents per pack) and New York has the highest ($4.35). In six states (Alabama, Illinois, Missouri, New York, Tennessee, and Virginia), local governments sometimes levy an additional cigarette tax. Local cigarette tax rates range from 1 cent per pack in Alabama and Tennessee to $4.18 per pack in Chicago (Cook County tax of $3.00, plus city tax of $1.18). Some states and cities levy their general sales taxes on the prices of cigarettes inclusive of the excise tax, while others include the general sales tax in the excise tax rate. Taxes are also levied on other tobacco products, including cigars and loose tobacco. There is new discussion about whether other nicotine delivery devices such as e-cigarettes should be taxed.

Alcohol taxes are generally paid at the wholesale level, so the cost is incorporated into the retail price. The excise taxes are levied per gallon (not as a percentage of the price), and beer, wine, and distilled spirits have different tax rates. In addition to the excise tax, many states also levy a general sales tax on the final purchase price of alcohol, and some states and cities have special sales tax rates for alcohol.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?

Motor fuel taxes are mostly per-gallon taxes. Consumers pay tax based on how much gas they purchase, not as a percentage of the final retail price of gasoline. However, 20 states and the District of Columbia tie at least a portion of their gasoline tax rate to the retail price. The lowest gasoline tax rate is in Alaska (8.95 cents per gallon) and the highest is in Pennsylvania (58.2 cents per gallon). States earmark much of their motor fuel tax revenue for transportation spending, which has meant funding gaps for transportation in recent years as gasoline consumption is decreasing. States are considering options like tying the gas tax rate to inflation and taxing miles traveled instead of gas to raise more revenue.

Some cities (e.g., Boston, San Francisco, and Washington, DC) also have special tax rates for specific goods and services (e.g., restaurant meals, hotel accommodations, rental cars, and parking) that are higher than their general sales tax rates. The higher tax rates on these purchases are often designed to collect a significant share of their revenue from visitors, who presumably have less political clout than local voters.

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Q. How do state and local property taxes work?

A. Jurisdictions in all 50 states and the District of Columbia impose property taxes. Most property tax revenue comes from levies on land and improvements, but states often tax personal property (such as machinery, equipment, and motor vehicles) as well. The tax equals a percentage of the taxable 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.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM PROPERTY TAXES?

While property taxes are a significant source of local government revenue, they are a very small revenue source for most states (table 1). State governments levy property taxes in 36 states, collecting $13 billion in revenue from such taxes in 2013—about 1 percent of own-source general revenue ("own-source" revenue excludes intergovernmental transfers). Vermont relied on property taxes for 26 percent of state own-source general revenue in 2013, far and away the highest percentage in any state. Property taxes were 5 percent or more of state revenue in only six other states: Arkansas, Michigan, Montana, New Hampshire, Washington, and Wyoming. Fourteen states did not levy a state-level property tax.

Local governments depend much more on property tax revenue. Local governments collected $442 billion from property taxes in 2013—47 percent of own-source general revenue. Property taxes provide three-quarters or more of local own-source revenue in six states; Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, and Rhode Island.

Property taxes are the largest own-source of revenue for counties, cities, townships, school districts, and special districts, which are specific-purpose units, such as water and sewer authorities. School districts rely quite heavily on property taxes, collecting $181 billion in 2012, which was 82 percent of their own-source general revenue. Because school districts receive substantial intergovernmental transfers, own-source revenue makes up less than half (about 45 percent) of their total general revenue.

The State of State (and Local) Tax Policy

How do state and local property taxes work?

TABLE 1

State and Local Property Tax Revenue
2013

	Revenue (billions)	Percentage of own source general revenue
State and local	$455	22%
State	$13	1%
Local	$442	47%

Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System

Note: Own source general revenue does not include intergovernmental transfers.

IN WHICH STATES ARE PROPERTY TAXES MOST IMPORTANT?

New Hampshire, which has neither a broad-based income tax nor a general sales tax, was the most reliant on property taxes in 2013, with property tax revenue accounting for 44 percent of combined state and local own-source general revenue. Property taxes also contributed more than 30 percent of state and local revenue in Connecticut, Maine, New Jersey, Rhode Island, and Vermont. All told, 11 states, including seven in the Northeast, collected at least one-quarter of their state and local own-source general revenue from property taxes (figure 1).

North Dakota relied least on property tax revenue in 2013, with less than 10 percent of its combined state and local own-source general revenue generated from property. Eleven states collected less than 15 percent of combined state and local revenue from property taxes.

HOW DO STATES LIMIT PROPERTY TAXES?

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. As a result, neighbors with similar houses may have dramatically different tax liabilities depending on when their houses last changed hands.

States and local governments also often use limits, exemptions, deductions, and credits to lower tax liability. Here are some examples:

- Assessment limits prevent a property's assessed value from increasing by more than a fixed percentage between assessments. These limits can reduce a property's assessed value below its market value and prevent rapid property value increases from raising the owner's tax burden. When the property is sold, its assessed value is reset at market value.
- Homestead deductions and exemptions decrease the taxable value of real property by a fixed amount (much the same way a standard deduction decreases taxable income) for residents who occupy the property. Forty-one states and DC have homestead exemptions that reduce the fraction of the assessed property value subject to tax.

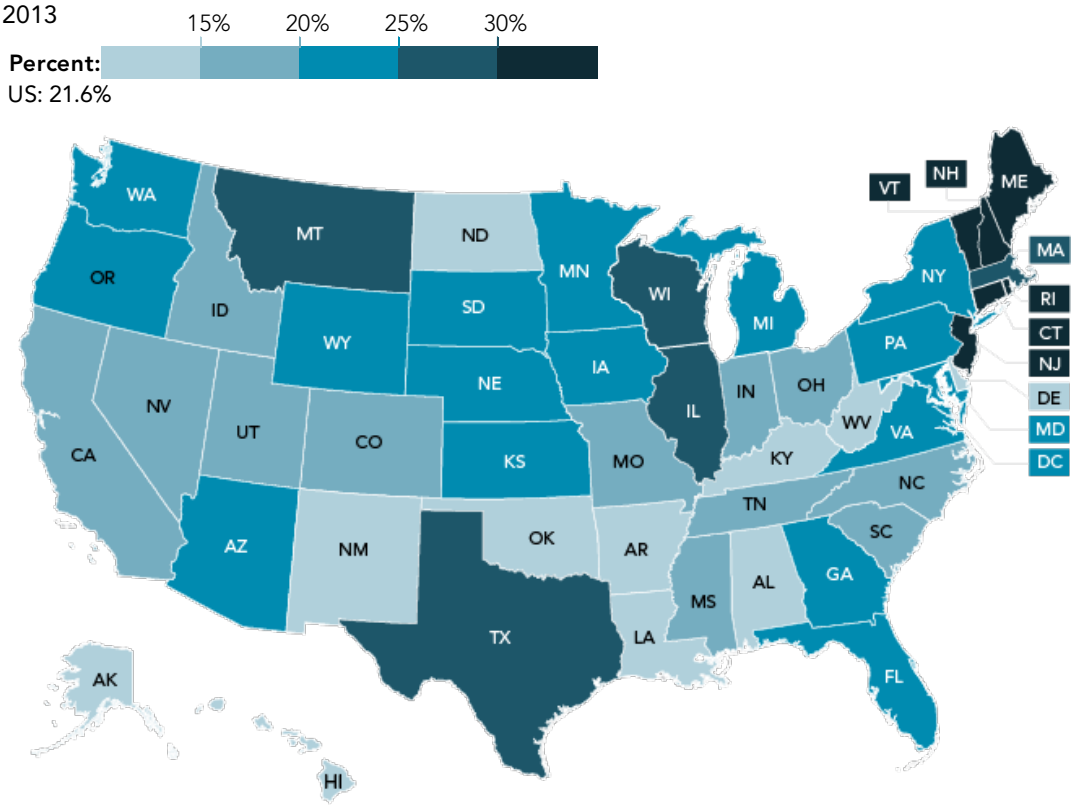
The State of State (and Local) Tax Policy

How do state and local property taxes work?

FIGURE 1

Property Tax Revenue as a Percentage of State and Local Own-Source General Revenue

2013



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.
Note: Own source general revenue does not include intergovernmental transfers.

- Circuit breaker programs provide relief for elderly and low-income residents with property tax liabilities above a specified percentage of their income. Although relief is based on property tax payments, it is typically provided via an income tax credit. In most states, the state government collects income tax while local jurisdictions collect property tax, making circuit breakers a type of subsidy from state to local governments. Unlike the other approaches described here, circuit breakers benefit renters as well as homeowners in some jurisdictions. Twenty-eight states and the DC use circuit breaker credits and refunds 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. All told, 22 states and the DC allow such deferrals, but they are not widely used.

The State of State (and Local) Tax Policy

How do state and local property taxes work?

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Q. How do state and local corporate income taxes work?

A. Forty-four states and the District of Columbia levy corporate income taxes. Ohio and Texas tax corporate gross receipts rather than income. Nevada, South Dakota, Washington, and Wyoming had no corporate income tax or gross receipts tax in 2016.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM CORPORATE INCOME TAXES?

State and local governments raise a relatively small share of revenue from corporate income taxes (table 1). States collected just $45 billion—4 percent of state own-source general revenue—from corporate income taxes in 2013 (own-source revenue excludes intergovernmental transfers). Local governments, including DC, collected only $8 billion—less than 1 percent of local government own-source general revenue. Only seven states allowed localities to levy a corporate income tax. New York City was responsible for 84 percent of corporate income tax revenue collected by local governments; DC accounted for another 6 percent.

TABLE 1

State and Local Corporate Income Tax Revenue
2013

	Revenue (billions)	Percentage of own source general revenue
State and local	$53	3%
State	$45	4%
Local	$8	1%

Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.
Note: Own source general revenue does not include intergovernmental transfers.

New Hampshire collected 13 percent of state own-source general revenue from corporate income taxes in 2013, the highest share of revenue of any state. Corporate income taxes were 5 percent or more of state revenue in eight other states; Alaska, Delaware, Illinois, Massachusetts, Minnesota, New Jersey, New York, and Tennessee—also in DC. Among the 44 states with corporate income taxes three (Hawaii, Louisiana, and South Dakota) collected less than 2 percent of revenue from the tax.

Corporate income tax revenue was 6 percent of local government own-source general revenue in New York, the only state among the seven that permit local government to levy a corporate income tax in which revenue from the tax was more than 2 percent of revenue. DC's corporate income tax provided nearly 6 percent of its own-source general revenue in 2013.

The State of State (and Local) Tax Policy

How do state and local corporate income taxes work?

WHAT INCOME IS TAXED?

Most states use the federal definition of corporate income as a starting point. However, states deviate from federal rules in some instances. For example, when the federal government enacted "bonus depreciation" in 2008, which allowed businesses to deduct a larger portion of capital investment in the year the investment is first made, many states did not enact conforming rules.

While states benefit from federal tax administration and enforcement by following the federal definition of corporate income, they must take additional steps in the case of multistate corporations to determine what portion of that income is taxable in their states.

States must first establish whether a company has "nexus" in the state, that is, enough physical or economic presence to owe income tax. Next, they must determine the taxable income generated by activities in the state. For example, multistate companies often have subsidiaries in no-tax or low-tax states that hold intangible assets such as patents and trademarks. The rent or royalty payments to those wholly owned subsidiaries may or may not be considered income of the parent company operating in another state. Finally, states must determine how much of a corporation's taxable income is properly attributed to that state.

Until recently, most states used a three-factor formula based on the Uniform Division of Income for Tax Purposes Act to determine the portion of corporate income taxable in the state. That formula gave equal weight to the shares of a corporation's payroll, property, and sales in the state. In the last 20 years, however, states have moved toward formulas that either weight more heavily or rely exclusively on sales within the state to apportion income. By using the portion of a corporation's sales rather than employment or property to determine tax liability, states hope to encourage companies to relocate or to expand their operations within these states.

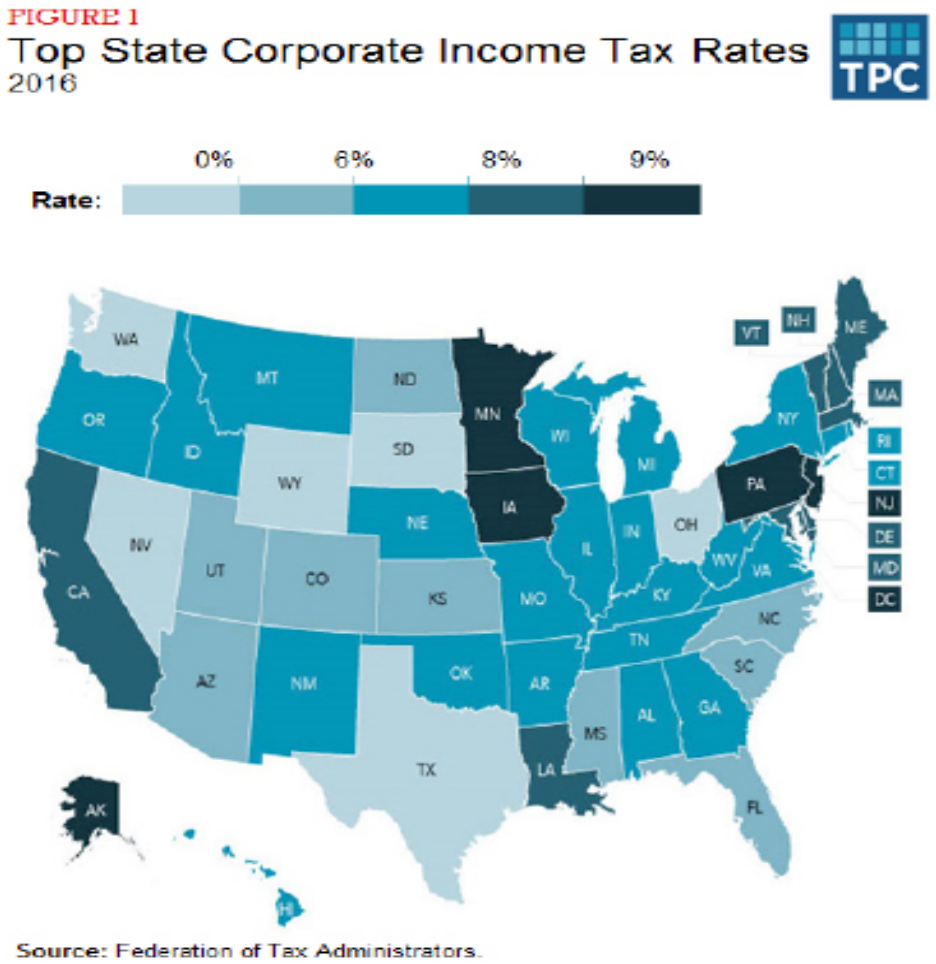
HOW MUCH DO CORPORATE INCOME TAX RATES DIFFER ACROSS STATES?

In 2016, top corporate income tax rates ranged from 4 percent (in Kansas and North Carolina) to 12.0 percent (in Iowa) (figure 1). Five states (Alaska, Iowa, Minnesota, New Jersey, and Pennsylvania) and DC had top corporate income tax rates at or above 9.0 percent. Nine others (Arizona, Colorado, Florida, Kansas, Mississippi, North Carolina, North Dakota, South Carolina, and Utah) had top rates below 6.0 percent.

Nevada, South Dakota, Washington, and Wyoming levied no corporate income taxes in 2015. Ohio and Texas taxed corporate gross receipts rather than income.

The State of State (and Local) Tax Policy

How do state and local corporate income taxes work?



Source: Federation of Tax Administrators.

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Q. How do state estate and inheritance tax work?

A. Eighteen states and the District of Columbia have either an estate tax or an inheritance tax. Maryland has both and New Jersey had both but repealed its estate tax as of 2018. Before 2001, when a federal credit offset the cost of state taxes, all states taxed the transfer of wealth at death.

In 2000 when all 50 states and the District of Columbia had an estate or inheritance tax, revenues from those taxes totaled $11 billion. In 2013, when only 19 states and D.C. had such taxes, revenues were $5 billion.

ESTATE OR INHERITANCE TAX?

Estate Tax

An estate tax is paid by the estate itself on the transfer of property at the time of a person's death. States must allocate assets across jurisdictions if the deceased person lived or owned property in multiple jurisdictions. Many of the states with estate taxes use the federal estate tax value as a starting point but vary in the exemptions allowed. The federal government exemption is $5.45 million in 2016, and current state exemptions are either equal to or less than the federal exemption.

Only 14 states and DC currently have estate taxes (figure 1). New Jersey is scheduled to repeal its estate tax starting in 2018. By contrast, in 2000, all states had estate taxes equal to the federal "credit for state death taxes" (CSDT); many of these states still have these taxes on their books in case the federal credit is restored.

Inheritance Tax

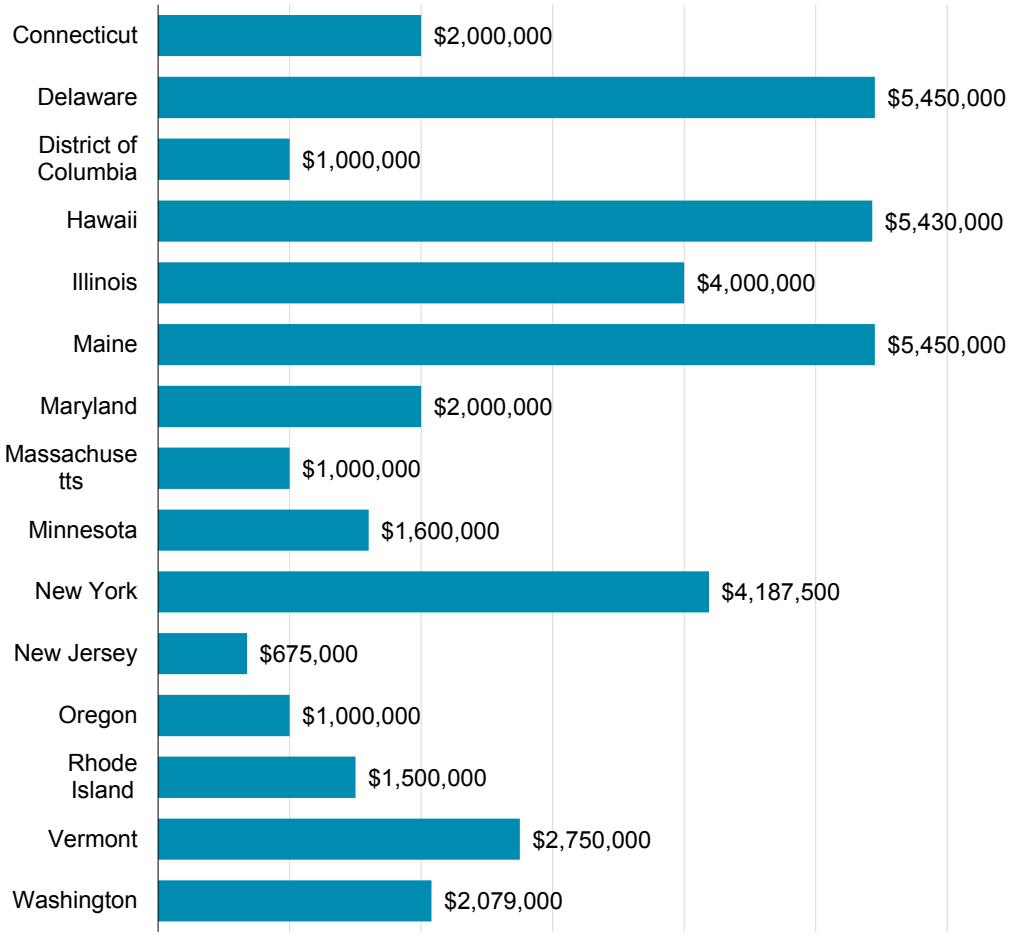
An inheritance tax is similar to the estate tax but the tax depends on the heir's relationship to the decedent. The tax is levied on the estate of residents or the in-state property of nonresidents at the time of death. There are exemptions for surviving spouses in all of the states with inheritance taxes; some also exempt direct descendants. Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania have inheritance taxes. Maryland and New Jersey have both an estate and in-heritance tax, but New Jersey recently repealed its estate tax effective January 1, 2018.

The State of State (and Local) Tax Policy

How do state estate and inheritance taxes work?

FIGURE 1

Exemption Amounts for States with Estate Taxes
2016



Source: Tax Policy Center.
Notes: The federal exemption threshold is $5,450,000. Hawaii, Delaware, and Maine use the same threshold. New York's exemption amount rises to $5,250,000 on April 1, 2017 and starting on January 1, 2019, will match the federal exemption. On or after April 1, 2017, and on or before December 31, 2018, the exemption amount for New York will rise to $5,250,000.

BACKGROUND

From 1924 to 2005, the federal government shared estate tax revenue with the states by allowing a credit for state estate and inheritance taxes. From 1924 to 1954, the credit was equivalent to 25 percent of the federal estate tax. After 1954, estates could claim a credit for state estate and inheritance taxes according to a progressive schedule with a top rate of 16 percent of the taxable value of the estate. As a consequence, rather than establishing unique taxes, states enacted estate taxes that equaled the maximum credit. In 2000, the last year the full credit was available, the state tax credits totaled $6.4 billion.

The State of State (and Local) Tax Policy

How do state estate and inheritance taxes work?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased out the credit, replacing it with a deduction that was less generous. The estate tax in many states was directly linked to the amount of the credit, and estate taxes would go to zero if they did not "decouple" from the federal law. In fact, 30 states let their tax go away by doing nothing. Fifteen states and DC did decouple, establishing separate estate taxes; five states explicitly repealed their taxes.

All of the provisions of EGTRRA were scheduled to expire in 2010 but were extended to 2012. In 2012, Congress did not address EGTRRA until the very end of the year, creating a fiscal cliff for most federal taxes and the possibility that the federal credit for state death taxes would return. In the end, Congress permanently replaced the state credit with a deduction for estate taxes paid to the states.

RECENT DEVELOPMENTS

Several states with estate or inheritance taxes have proposed or enacted changes. Indiana recently repealed its inheritance tax, while Kansas, North Carolina, Ohio, Oklahoma, and Tennessee re-pealed their estate taxes. Delaware, Hawaii, and Maine adjusted their exemptions to conform to the federal exemption. The District of Columbia will conform to the federal exemption if reve-nues are higher than projected. Maryland, Minnesota, and Rhode Island have all recently in-creased their exemptions.

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Q. How do state earned income tax credits work?

A. States typically structure their earned income tax credit (EITC) as a percentage of the federal EITC. In 2016, state EITCs varied from 3.5 to 40 percent of the federal credit. Some state EITCs are not refundable, which make them much less valuable to very low-income families who rarely owe income tax.

Twenty-six states and the District of Columbia had their own earned income tax credit in 2016, although Washington's credit has never been implemented or funded. Washington is the only state without an income tax to have an earned income tax credit.

All but one state set their credits as a percentage of the federal credit, the exception being Minne-sota which calculates its credit as a percentage of income (table 1). State credits varied from 3.5 percent of the federal EITC in Louisiana and North Carolina to 40 percent of the federal credit in DC. California's credit is 85 percent of the federal credit but is based on a smaller earnings range than the federal EITC. Setting state credits as a percentage of the federal credit avoids added complexity for families filing a state income tax return. After filling out a federal tax return, fam-ilies can use that information to calculate their state credit on their state tax return.

The state EITC is refundable in all but three states (Delaware, Ohio, and Virginia). A non-refundable EITC can only offset state income taxes but no other state-level taxes paid by low-income working families.

The State of State (and Local) Tax Policy

How do state earned income tax credits work?

TABLE 1

Description of State Earned Income Tax Credits
2016

State	Year enacted	Refundable	Percentage of federal EITC
California	2015	Yes	85 percent of the federal credit, up to half of the federal phase-in
Colorado	1999 (replaced) 2013 (enacted; funded in 2015)		10
Connecticut	2011	Yes	27.5, 30 in 2016
Delaware	2005	No	20
District of Columbia	2000	Yes	40
Illinois	2000	Yes	10
Indiana	1999	Yes	9
Iowa	1989	Yes	15
Kansas	1998	Yes	17
Louisiana	2007	Yes	3.5
Maine	2000	Yes	5
Maryland	1987	Yes	Refundable: 25; nonrefundable 50
Massachusetts	1997	Yes	23
Michigan	2006	Yes	6
Minnesota	1991	Yes	Varies
Nebraska	2006	Yes	10
New Jersey	2000	Yes	30
New Mexico	2007	Yes	10
New York	1994	Yes	30
Ohio	2013	No	10, limited to 50 percent of liability for Ohio Taxable Income over $20,000
Oklahoma	2002	Yes	5
Oregon	1997	Yes	8
Rhode Island	1986	Yes	12.5
Vermont	1988	Yes	32
Virginia	2004	No	20
Washington	2008 (but not yet implemented)	Yes	10 (or $50, whichever is greater)
Wisconsin	1989	Yes	4 for families with one child; 11 for families with two children; 34 for families with three children

Source: Tax Credits for Working Families.

The State of State (and Local) Tax Policy

How do state earned income tax credits work?

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Q. How do state and local severance taxes work?

A. Thirty-five states levy severance taxes, which are taxes on the extraction of natural resources (including oil and natural gas). The revenue from these taxes is extremely volatile because it rises and falls with the price and production of natural resources.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM SEVERANCE TAXES?

State and local governments collected $1.7 billion from severance taxes in 2013. Nearly all of that ($1.6 billion) came from state taxes; only 11 states allow local severance taxes. This revenue only accounted for 1 percent of national state and local general revenue, but severance taxes provide a substantial amount of revenue in a few resource-rich states, such as Alaska, North Dakota, and Wyoming (figure 1).

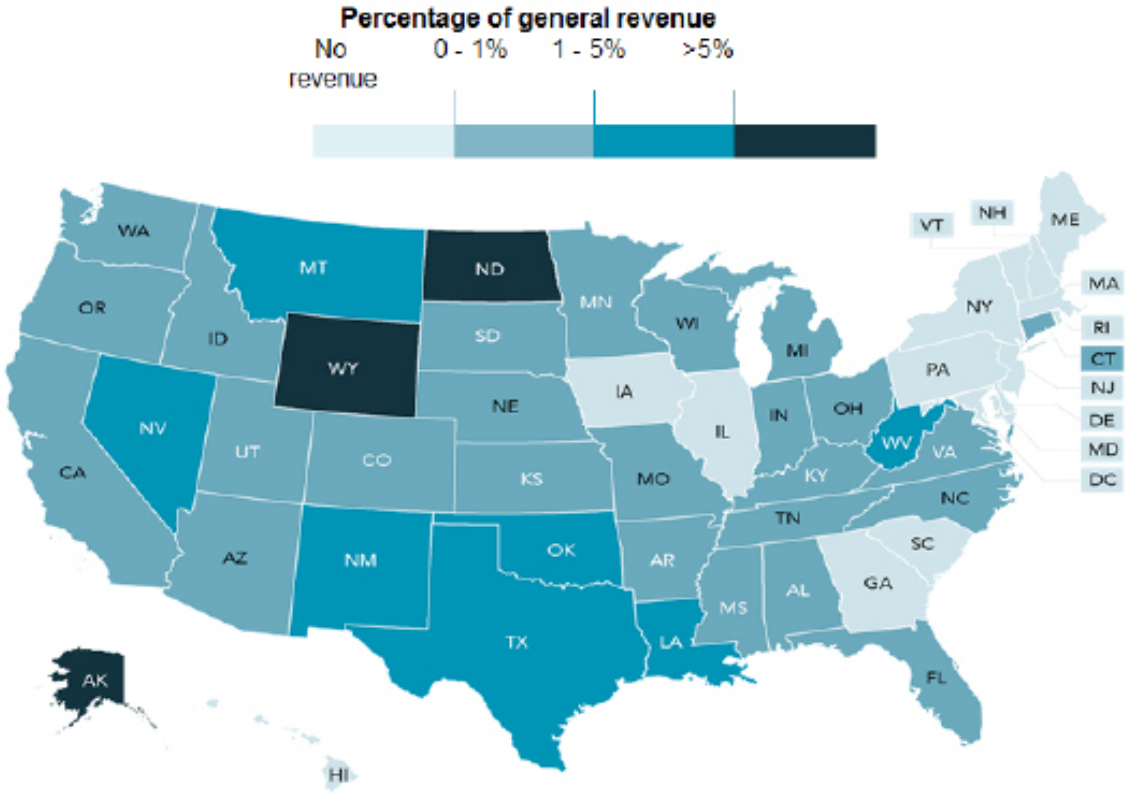
The State of State (and Local) Tax Policy

How do state and local severance taxes work?

FIGURE 1

Severance Tax Revenue

2013



Source: US Census Bureau, Census of Governments.

Alaska relied on severance tax revenue more than any other state in 2013, with severance taxes accounting for 27 percent of combined state and local own-source general revenue. Severance taxes were also a substantial percentage of combined state and local revenue in North Dakota (24 percent) and Wyoming (10 percent). In no other state were severance taxes more than 5 percent of general revenue, but they accounted for more than 1 percent in Louisiana, Montana, Nevada, New Mexico, Oklahoma, Texas, and West Virginia. Fifteen states and the District of Columbia do not levy severance taxes.

HOW HAVE FALLING OIL AND GAS PRICES AFFECTED SEVERANCE TAX REVENUE?

Since these data on severance revenue were reported in 2013, the price and production of oil and other natural resources have sharply declined, as has state severance tax revenue. Alaska's state severance tax revenue, in the most extreme example, fell from $1.3 billion in 2014 to less than $200 million in 2015. The volatility of severance taxes poses a challenge to states that use them as an important revenue source, requiring such states to have flexible budgeting arrangements, other readily exploitable revenue sources, or significant rainy-day funds to accommodate unforeseen changes in severance revenue flows.

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Q. How does the deduction for state and local taxes work?

A. Taxpayers who itemize deductions on their federal income tax returns can deduct state and local real estate and personal property taxes as well as either income taxes or general sales taxes.

State and local income and real estate taxes make up the bulk of total state and local taxes deducted (about 60 percent and 35 percent, respectively), while sales taxes and personal property taxes account for the remainder. The state and local tax (SALT) deduction is one of the largest federal tax expenditures, with an estimated revenue cost of $96 billion in 2017 and $1.3 trillion over the 10-year period from 2017 to 2026. (Tax expenditures are defined as "those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.")

State and local taxes have been deductible since the inception of the federal income tax in 1913. Initially, all state and local taxes not directly tied to a benefit were deductible against federal taxable income. In 1964, deductible taxes were limited to state and local property (real and personal property), income, general sales, and motor fuels taxes. Congress eliminated the deduction for taxes on motor fuels in 1978, and eliminated the deduction for general sales tax in 1986. It temporarily reinstated the sales tax deduction in 2004, allowing taxpayers to deduct either income taxes or sales taxes, but not both. Subsequent legislation made that provision permanent starting in 2015.

WHO CLAIMS THE SALT DEDUCTION?

About one-third of tax filers opt to itemize deductions on their federal income tax returns (figure 1), and virtually all who do itemize claim a deduction for state and local taxes paid. High-income households are more likely than low- or moderate-income households to benefit from the SALT deduction. The amount of state and local taxes paid, the probability that taxpayers itemize their deductions, and the reduction in federal income taxes for each dollar of state and local taxes deducted all increase with income.

About 10 percent of tax filers with incomes less than $50,000 claimed the SALT deduction in 2014, compared with about 81 percent of tax filers with incomes exceeding $100,000. The latter group, which made up about 16 percent of tax filers, accounted for about 75 percent of the total dollar amount of SALT deductions claimed. The average claim in this affluent group was of about $12,300.

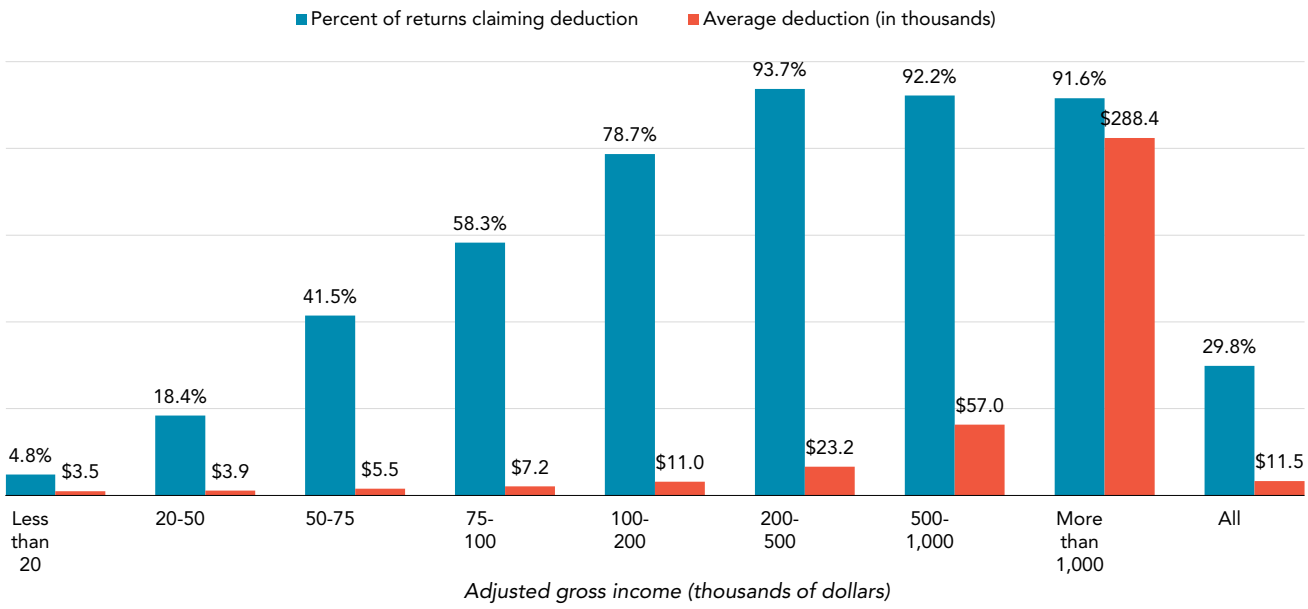
The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

FIGURE 1

Share of Returns Claiming the State and Local Deduction, and Average Deduction Claimed

By income group, 2013



Source: Urban-Brookings Tax Policy Center based on data from the Internal Revenue Service.

Although most high-income taxpayers claim a SALT deduction, the federal individual alternative minimum tax (AMT) limits or eliminates the benefit for many of them. The AMT is a parallel income tax system with fewer exemptions and deductions than the regular income tax as well as a narrower set of tax rates. Taxpayers potentially subject to the AMT must calculate their taxes under both the regular income tax and the AMT and pay the higher amount. Taxpayers cannot claim the SALT deduction when calculating their AMT liability, and the disallowance of the deduction is the major reason why taxpayers are required to pay the AMT.

Although some taxpayers in every state and the DC claim the deduction, taxpayers in states with a disproportional share of high-income taxpayers and relatively high state and local taxes are more likely to claim the deduction (figure 2). The percentage claiming the deduction ranged from 17 percent in South Dakota and West Virginia to 45 percent in Maryland. In general, a higher percentage of taxpayers in states in the Northeast and the West claimed the deduction than in states in other regions. The average deduction claimed was also higher in those regions.

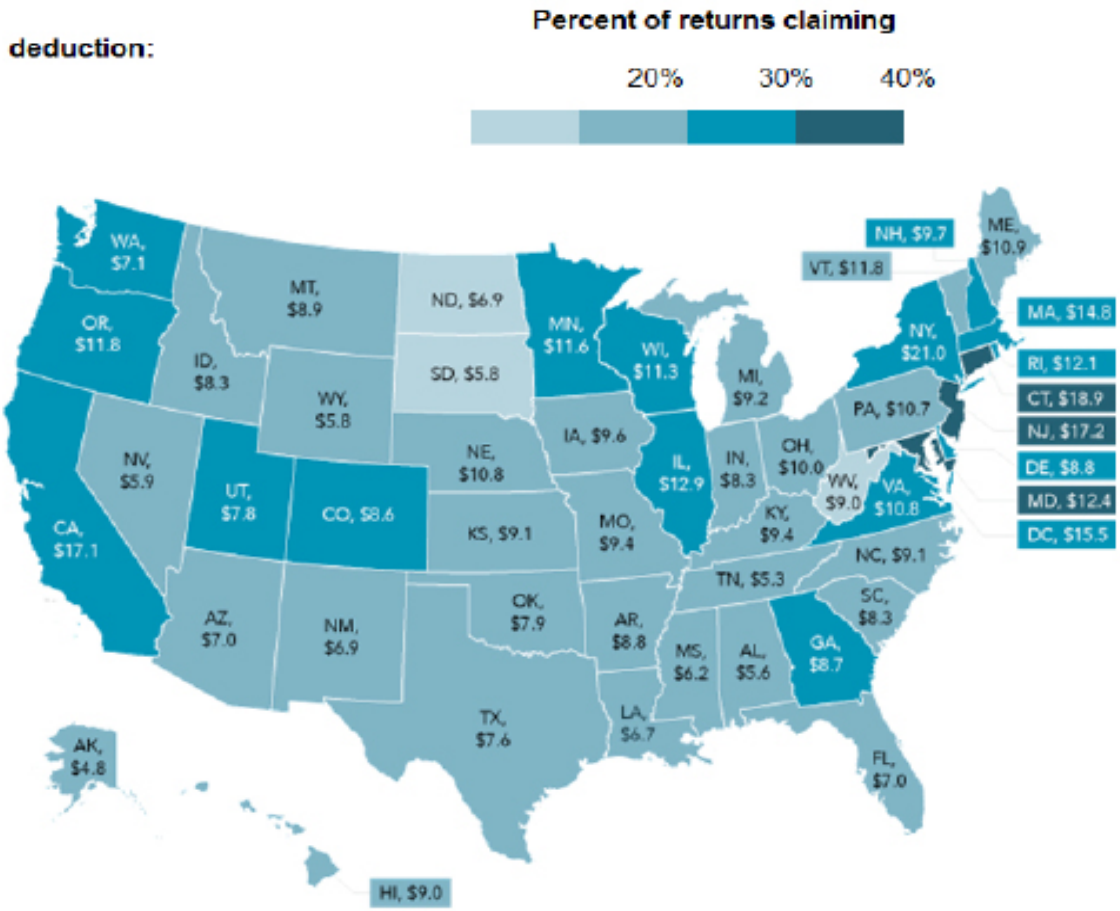
The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

FIGURE 2

Returns Claiming the State and Local Tax Deduction and Average Deduction Claimed by State

Average deduction in thousands of dollars, 2014



Source: Urban-Brookings Tax Policy Center based on data from IRS: SOI Tax Stats - Historic Table 2. Tax Year 2014.

EFFECTS OF THE DEDUCTION

The SALT deduction provides an indirect federal subsidy to state and local governments by decreasing the net cost of nonfederal taxes to those who pay them. For example, if state income taxes increase by $100 for families claiming the SALT deduction on their federal returns who are in the 35 percent federal income tax bracket, the net cost to them is $65; that is, state taxes go up by $100, but federal taxes go down by $35. This federal tax expenditure encourages state and local governments to levy higher taxes (and, presumably, provide more services) than they otherwise would. It also encourages those entities to use deductible taxes in place of nondeductible taxes (such as selective sales taxes on alcohol, tobacco, and gasoline), fees, and other charges.

Critics of the deduction argue that state and local taxes simply reflect payments for services provided by

those jurisdictions and, as such, should be treated no differently than other forms of spending. They also point to the uneven distribution of benefits across income groups and states.

Proponents of the deduction counter that the portion of an individual's income claimed by state and local taxes is not really disposable income, and that taxing it at the federal level is double taxation. Moreover, they argue that federal subsidies are warranted because a significant portion of state and local government spending is for education, health, public welfare, and transportation, all of which have important spillovers that benefit the population in other jurisdictions as well. A counterargument, however, is that while federal support may be warranted, the substantial revenues gained by eliminating or limiting the deduction could be used to provide direct support through federal grants and loans.

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Q. What are municipal bonds and how are they used?

A. Municipal bonds (a term that encompasses both state and local government debt) are obligations that entitle owners to interest plus repayment of principal at a specified date. States and localities (cities, townships, counties, school districts, and special districts) issue bonds to pay for large, expensive, and long-lived capital projects, such as roads and schools.

State and local governments issue bonds to pay for large, expensive, and long-lived capital projects, such as roads and water treatment facilities. Although states and localities can and sometimes do pay for capital investments with current revenues, borrowing allows them to spread the costs across multiple generations. Future infrastructure users bear some of the cost through higher taxes or tolls that service the debts.

State and local governments borrow mainly by issuing bonds. Investors may buy bonds and hold them to maturity, or they may sell them on secondary markets. Bonds are often described in terms of their yield, or the interest rate that equates prices to cash flows. Bond prices and yields are inversely related to one another, so when prices rise, yields fall.

HOW LARGE IS THE MUNI BOND MARKET?

At the end of 2014, state and local governments had $3.65 trillion in debt outstanding (figure 1). Although the level of municipal debt has more than tripled in nominal terms since the mid-1980s, it has remained relatively stable as a percentage of GDP (15 to 20 percent). In fiscal year 2012, the latest year for which breakdowns are available, state governments were responsible for 40 percent and localities for 60 percent of the debt outstanding.

About 98 percent of this debt was issued for longer than one year. States and localities also borrow over the short term to smooth uneven cash flows (e.g., when tax revenues arrive in April but expenditures occur throughout the year).

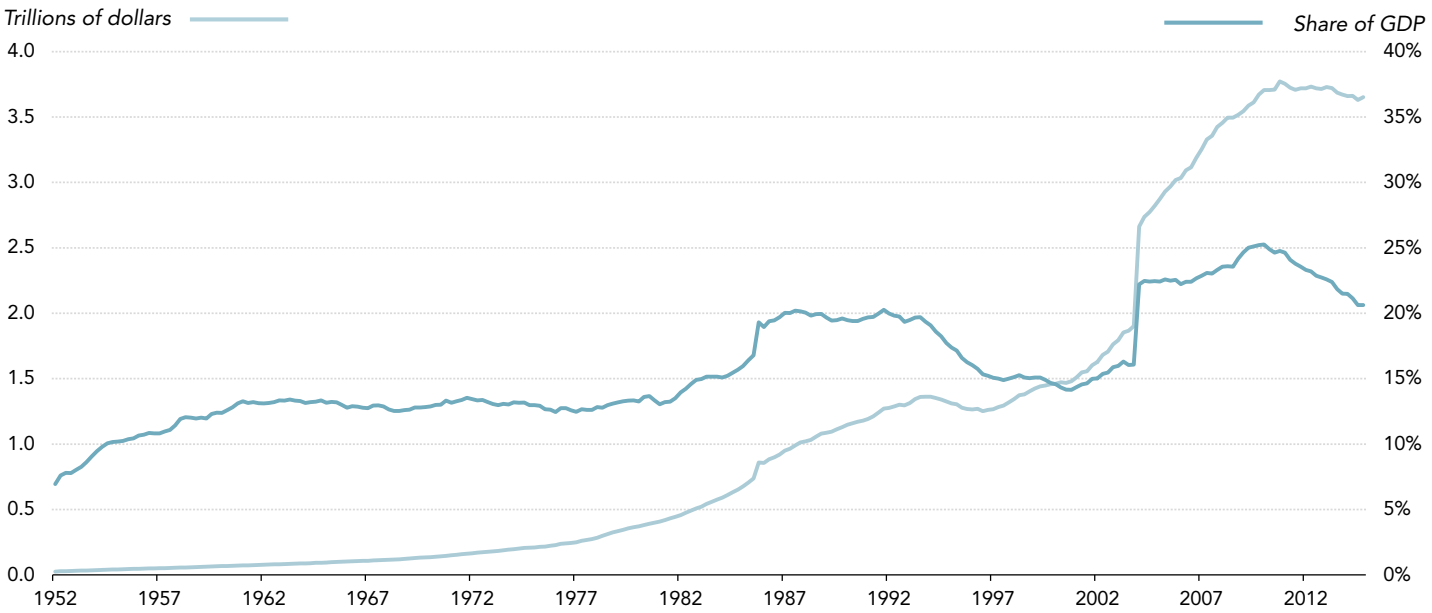
States vary widely in their long-term municipal debt outstanding (figure 2).

The State of State (and Local) Tax Policy

What are municipal bonds and how are they used?

FIGURE 1

State and Local Government Debt Outstanding
1952–2012



Source: Federal Reserve Bank, March 2015.
Note: Starting in the first quarter of 2004, the Federal Reserve made a one time $800 billion adjustment to the stock of municipal debt oustanding.

WHAT ARE THE MAIN TYPES OF STATE AND LOCAL GOVERNMENT DEBT?

General obligation (GO) bonds are generally considered the most secure form of municipal debt because they are backed by an issuer's "full faith and credit," including its power to tax. Bonds may also be secured by future revenue streams, such as tolls or other user charges and are called revenue bonds.

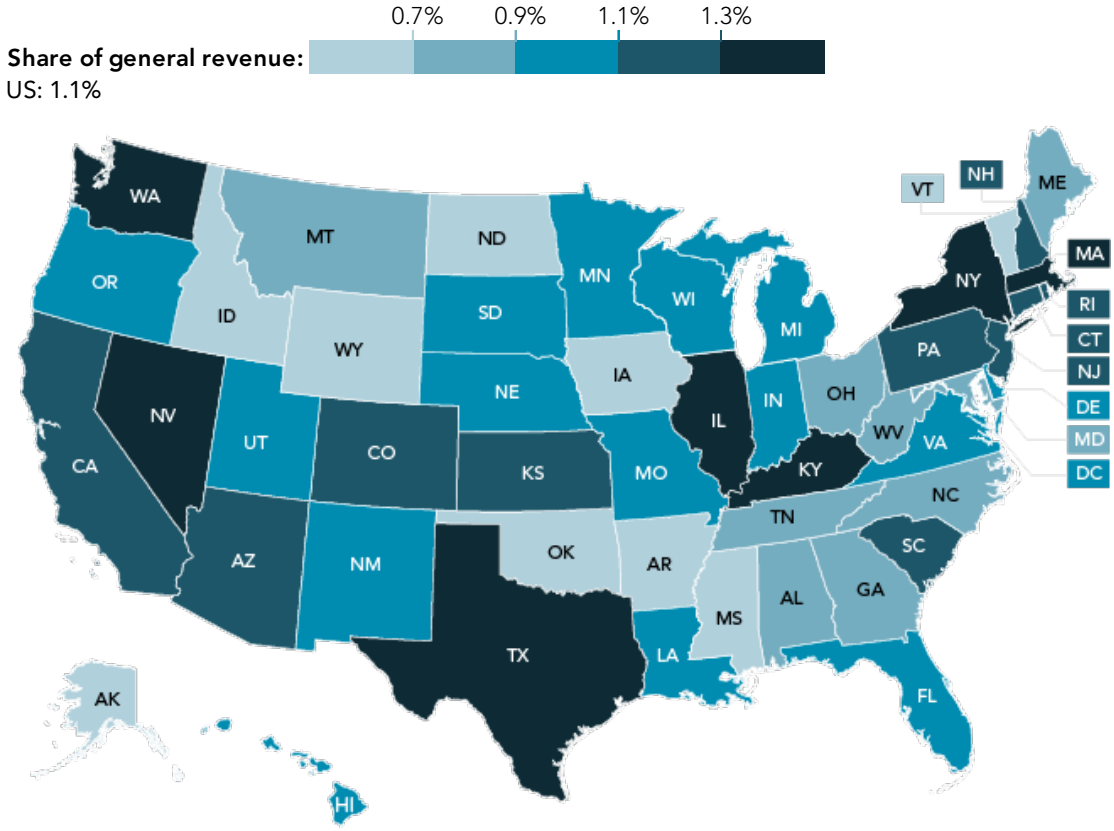
GO bonds typically require voter approval and are subject to limits on total debt outstanding. Revenue bonds and bonds secured by anticipated legislative appropriations are not subject to these requirements or limits. In addition to new borrowing, state and local governments may issue bonds to refinance or "refund" existing debt.

In 2014, roughly 60 percent of state and local issuances were revenue bonds and 40 percent were GO bonds. Issuances were lower than average and more heavily weighted than usual toward refunding, similar to a refinancing. Issuers were seeking to take advantage of low interest rates but were reluctant to issue new debt as revenue growth remained sluggish in the wake of the Great Recession.

FIGURE 2

Long-Term Outstanding Debt

2012



Source: US Census Bureau.

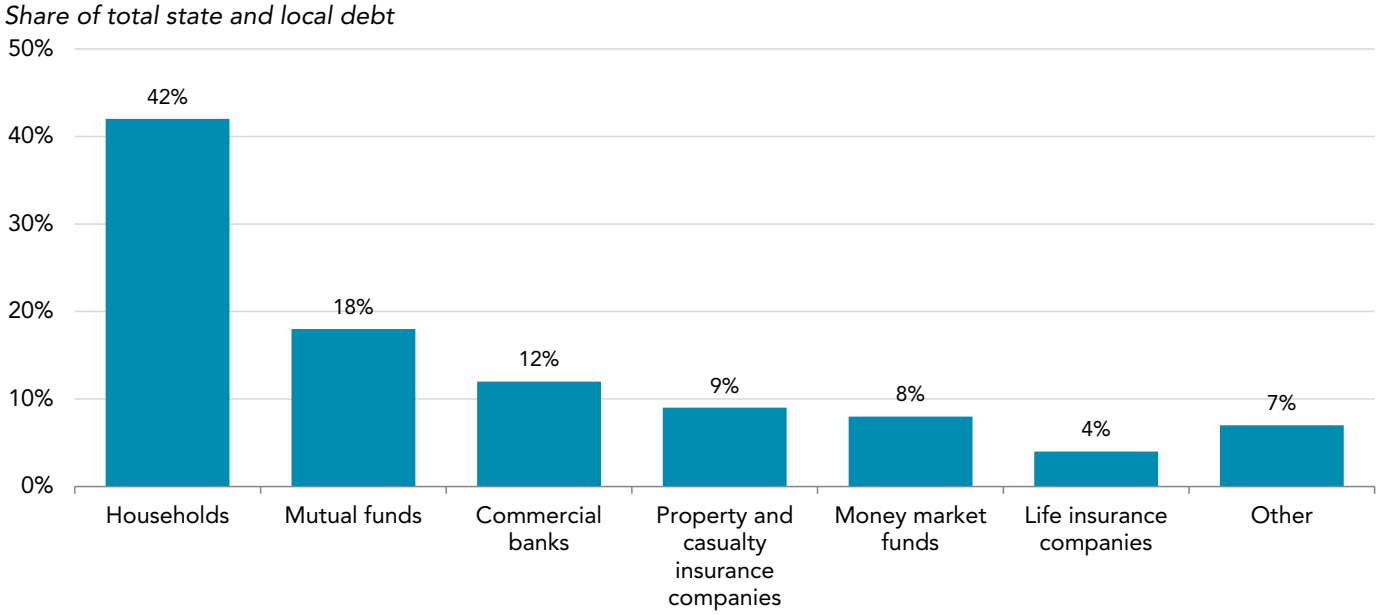
WHO HOLDS STATE AND LOCAL GOVERNMENT DEBT?

The largest quantity is held by households, followed by mutual funds (which also includes household investors) (figure 3). Banks and life insurance companies used to be more prominent municipal bond holders until the Tax Reform Act of 1986 and subsequent litigation limited the advantages of doing so.

FIGURE 3

Holders of State and Local Debt

2nd quarter, 2015



Source: Federal Reserve Bank, March 2015.
Notes: "Other" category includes: closed-end funds, foreign investors, brokers and dealers, nonfinancial corporate businesses, government-sponsored enterprises, savings institutions, exchange-traded funds, state and local government general funds, and state and local government retirement funds.

HOW DOES THE FEDERAL TAX EXEMPTION WORK AND WHAT ARE PROPOSALS FOR REFORM?

Since its inception in 1913, the federal income tax has exempted interest payments received from municipal bonds (a term that encompasses both state and local debt) from taxable income. State and local governments also typically exempt interest on bonds issued by taxpayers' state of residence. However, the US Supreme Court in *Department of Revenue of Ky. v. Davis* upheld states' ability to tax interest on bonds issued by other jurisdictions, though some jurisdictions, including the District of Columbia, do not tax municipal debt from any state.

Because of the tax exemption, state and local governments can borrow more cheaply than other debt issuers, such as corporations, for a given level of risk and length of maturity. The federal tax exemption therefore functions as a federal subsidy to state and local public infrastructure investment. This subsidy comes at a cost in foregone tax revenues, which amounted to $29 billion in fiscal 2014.

The tax exemption has been criticized as inefficient because high-bracket taxpayers receive more than the inducement needed to purchase municipal bonds. In 2007, for example, a high-grade taxable municipal bond (some do not qualify for the exemption) yielded 5.6 percent. The yield for a comparable tax-exempt bond was 4.4 percent. Thus, taxpayers in the 21 percent bracket should be just indifferent between the two types of bonds (the gap in yields—1.2 percentage points—is about 21 percent of 5.6 percentage points). Anyone in a higher bracket receives a windfall that generates no additional benefit for the borrower.

In light of this inefficiency, proposals have long circulated to cap the federal tax exemption (e.g., at 28 percent in President Obama's FY2016 and prior budgets) or to augment tax-exempt bonds with taxable bonds providing a direct subsidy to issuers as a tax credit to bondholders. The President's FY2016 budget included such a taxable bond proposal modeled after the 2009 American Recovery and Reinvestment Act's Build America Bonds. However, the revenue gain from eliminating or capping the deduction depends on whether bondholders responded by shifting their portfolios toward taxable bonds or other investments (Verdugo and Poterba 2011).

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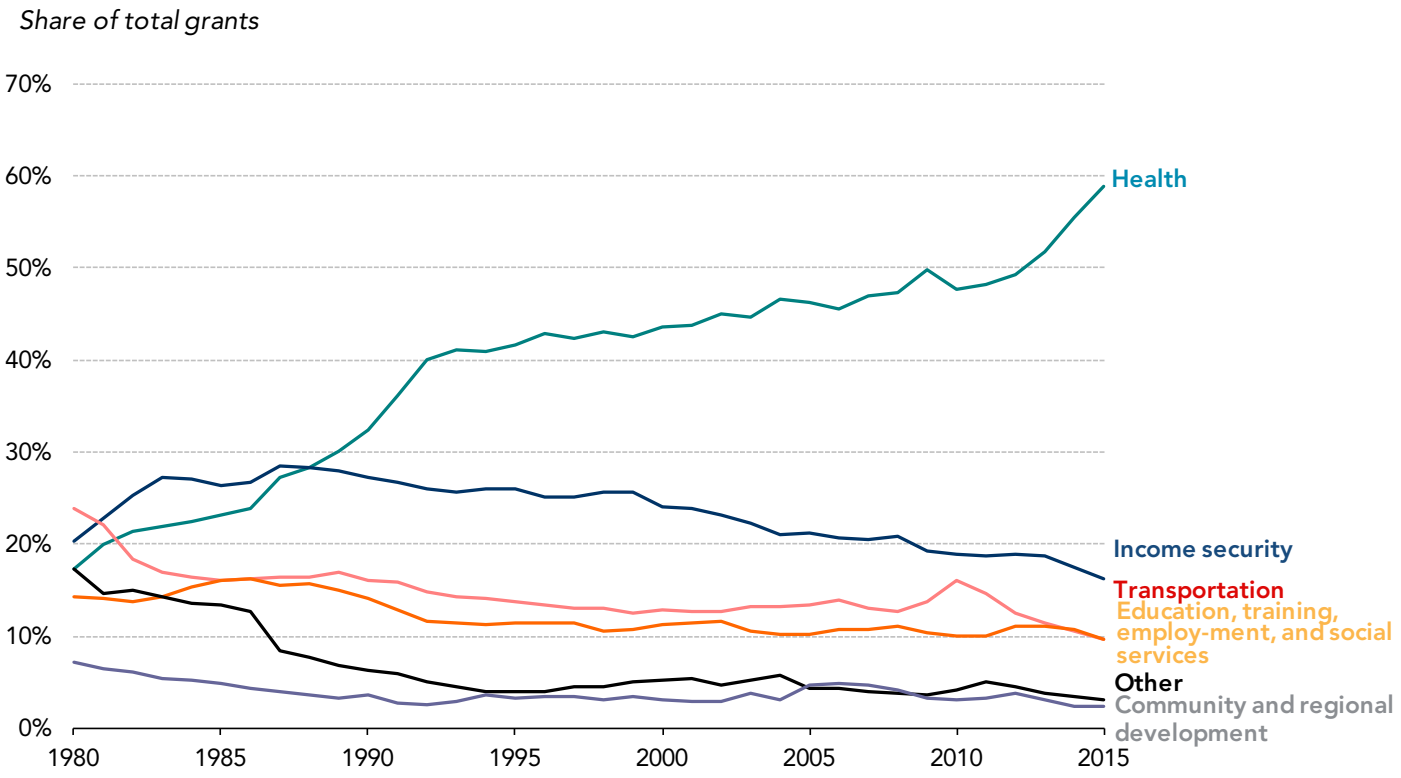
Q. What types of federal grants are made to state and local governments and how do they work?

A. The federal government distributes around $530 billion, about 14 percent of its budget, each year to states and localities, providing about a quarter of these governments' general revenues. The bulk of the funds are dedicated to health care (figure 1).

FIGURE 1

Federal Grants to State and Local Governments by Category
1980-2015



The State of State (and Local) Tax Policy

What types of federal grants are made to state and local governments and how do they work?

The federal government distributes grants to state and local governments for several purposes. In some cases, the federal government may devolve or share responsibility for a given service or function because state and local governments have better information about local preferences and costs. In others, the federal government may offer incentives to states and localities to undertake additional spending benefiting neighboring jurisdictions or the country as a whole. Less common are grants targeted to redistributing resources across jurisdictions, such as the General Revenue Sharing program that ended in 1986. Over the past 50 years, the composition of federal grants has shifted dramatically. Today, federal grants for health programs, predominantly Medicaid, represent 55 percent of total federal grant outlays, compared with 20 percent in 1980.

There are two types of federal grants. Categorical grants are restricted to a narrow purpose, such as providing nutrition to lower-income pregnant and postpartum women, infants, and children under the Special Supplemental Nutrition Program for Women, Infants, and Children, also known as WIC. Even more restricted are grants limited to specific projects, such as building a highway. Block grants give recipients more latitude in meeting program objectives, such as as-sisting needy families and promoting work under the Temporary Assistance for Needy Families (TANF) program. States also set TANF eligibility requirements within federal parameters.

Federal grants may also be classified according to how funds are awarded. Formula grants allo-cate federal dollars to states based on formulas set in law and linked to factors such as the num-ber of highway lane-miles, school-aged children, or low-income families. A prime example is the federal-state Medicaid program, which provides subsidized health insurance to low-income households.

Grants may also be awarded competitively according to specified criteria as in the Race to the Top or Transportation Investment Generating Economic Recovery (TIGER) awards. In addition, grants may require states and localities to contribute their own funds (matching requirements) or maintain previous spending levels despite the infusion of federal cash (maintenance of effort re-quirements).

Beyond grants, the federal government also subsidizes state and local governments by allowing federal income taxpayers to deduct state and local taxes already paid and by excluding bond in-terest from taxable income. The value of these subsidies has been estimated at $122 billion in foregone dollars to the US Treasury in FY2016 (Office of Management and Budget, 2016).

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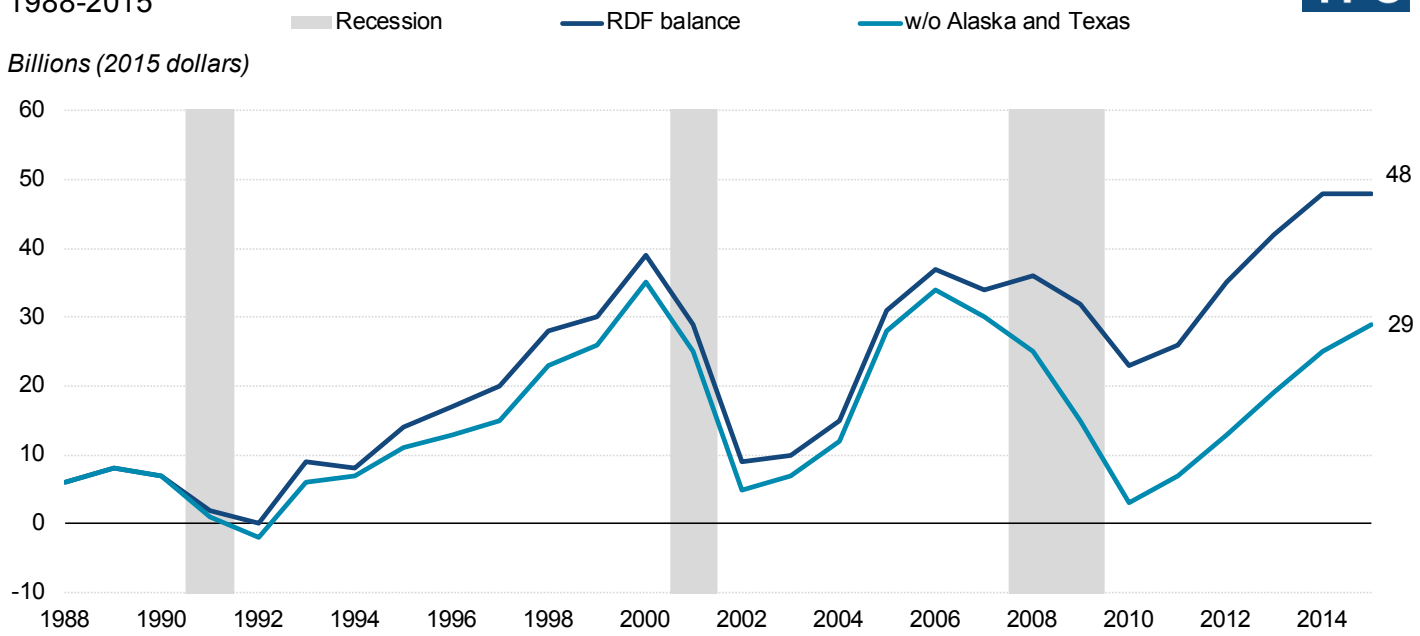
Q. What are state rainy day funds, and how do they work?

A. Budget stabilization funds allow states to set aside surplus revenue for times of unexpected revenue shortfall or budget deficit. Every state but Arkansas, Kansas, and Montana has some type of rainy day fund.

FIGURE 1

Rainy Day Fund Balance
1988-2015



Sources: National Association of State Budget Officers; Bureau of Labor Statistics for CPI.

The State of State (and Local) Tax Policy

What are state rainy day funds and how do they work?

SOURCES OF FUNDING

How rainy day funds (RDFs) are funded varies state to state (table 1). Most allow some or all year-end surplus to flow to the RDF. Other states require specified set-asides every year until the fund reaches its cap. A few states replenish with specific appropriations as part of the budget process. Finally, some RDFs have dedicated sources of revenue. Natural resource–rich states dedicate a portion of revenue from extraction to various reserve funds. Recently, California and Massachusetts dedicated a portion of capital gains tax revenue to RDFs.

TABLE 1

Rainy Day Fund Funding Mechanisms

Funding mechanism	States
Year end surplus deposited in RDF	Alaska, Delaware, Georgia, Iowa, Kentucky, Maryland, Massachusetts, Mississippi, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma
Portion of year end surplus deposited in RDF	Louisiana, Maine, Minnesota, Nevada, New Jersey, Pennsylvania, Texas, Utah, West Virginia, Wisconsin
Automatic deposit - certain percentage of revenues or appropriations	Alabama, California, Colorado, Connecticut, District of Columbia, Florida, Hawaii, Missouri, Rhode Island, South Carolina, Tennessee, Vermont, Washington
Deposit triggered by revenue growth	Arizona, Idaho, Indiana, Nebraska
Other	Illinois, Michigan, Oregon, South Dakota, Virginia, Wyoming
No RDF	Arkansas, Kansas[a], Montana

Source: National Association of State Budget Officers.
(a) Although Kansas enacted a budget stabilization fund in 2016, the state has not yet established a mechanism to fund it.

USE OF FUNDS

In most states, the RDF is dedicated to closing fiscal gaps in the current year or maintaining gov-ernment spending when revenues are projected to decline. However, some states use funds only for specific purposes. For example, Colorado's fund can only be used to cover shortfalls caused by natural disasters.

The means of access varies; some states allow transfers from the RDF to be included in normal appropriations bills, while others require an emergency declaration or a super-majority (three-fifths or two-thirds) of the legislature to make a transfer. Several states also allow the RDF to be used to cover short-term cash flow gaps. Funds are transferred to the general fund and must be paid back by the end of the fiscal year.

The State of State (and Local) Tax Policy

What are state rainy day funds and how do they work?

CAPS

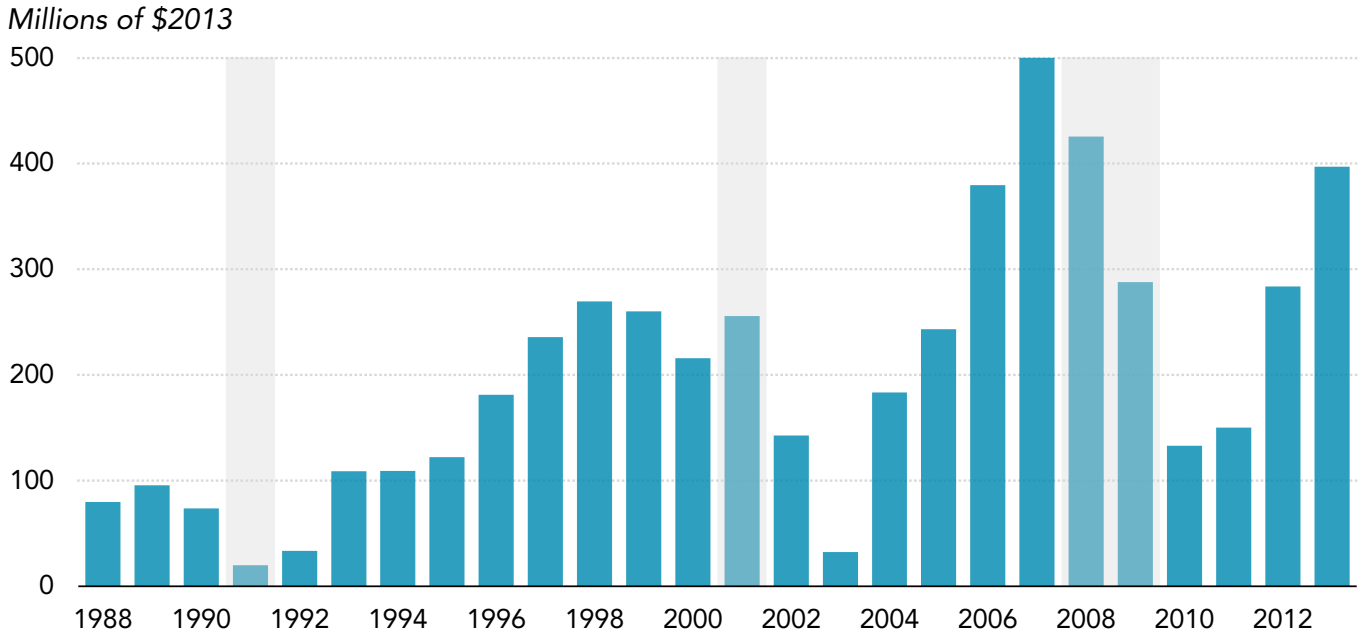
Twenty-five states cap the balances of their funds. The cap is either a percentage of revenue or expenditure. Most states that fund RDFs with operating surpluses stop transfers once the cap has been reached. But a few redirect surpluses to other funds for special projects or taxpayer relief. New Mexico, for example, has a "cascading" fund balance. The operating reserve is capped at 8 percent, and any excess goes to the tax stabilization reserve. This reserve is also capped, and its excess flows to the taxpayer dividend fund. Other states have separate reserve funds for educa-tion or Medicaid spending designed to cover shortfalls in these vital programs.

MITIGATING FISCAL CRISIS

An economic downturn can cause significant fiscal stress for states because without changes in policy, revenues decline even as demands on programs such as unemployment insurance and Medicaid increase. Savings in rainy day funds help them weather a fiscal downturn with fewer expenditure cuts. The median balance of state RDFs declined significantly after the last three recessions and then built back up (figure 3).

FIGURE 2

Median Balance of Rainy Day Funds
1988-2013



Source: NASBO Survey of State Finances, various years.

The State of State (and Local) Tax Policy

What are state rainy day funsd and how do they work?

Capping the amount in the RDF is a sensible approach to preventing the unnecessary build-up of restricted funds, but the cap has to be set appropriately. The rule of thumb had been 5 percent of expenditures, but the Great Recession has made states reconsider. Only 5 of the 25 states with caps top out at 5 percent or less. The Government Finance Officers Association recommends two months of expenditures, or about 16 percent, though only four states had RDF balances above 16 percent at the end of 2013, and all were natural resource–rich states (Alaska, North Dakota, West Virginia, and Wyoming).

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Q. What are tax and expenditure limits?

A. Tax and expenditure limits (TELs) restrict the growth of government revenues or spending by either capping them at fixed dollar amount or limiting their growth rate to match increases in population, inflation, personal income, or some combination of those factors. As of 2015, 28 states had at least one TEL.

DESIGNING TAX AND EXPENDITURE LIMITS

Spending versus revenue limits

Limits can be placed on revenue, appropriations, or both. Many states, for example, have a mechanism in place to restrict the growth of property taxes, but this is more often a restraint imposed by the state on local governments. Typically, states limit the ability to appropriate or spend funds rather than limit revenue collected. In 2015, 26 states imposed limits on their own government spending. By contrast, only two limited revenue; these two also capped spending.

Mechanism

The means used to limit spending and revenue varies. The limit can either be a cap on growth or a restriction on the level. The most common formula restricts expenditure growth to the pace of personal income. But some states include population and inflation growth in the formula. And others restrict expenditures to a level determined by a formula, such as a set percentage of personal income.

Idaho, for example, limits expenditures to 5.33 percent of state personal income, there-by allowing expenditures to grow at the same rate as personal income. Another method is to restrict expenditures to a percentage of projected revenue, maintaining a cushion in case revenues fall short of the projection.

What are tax and expenditure limits?

Stringency

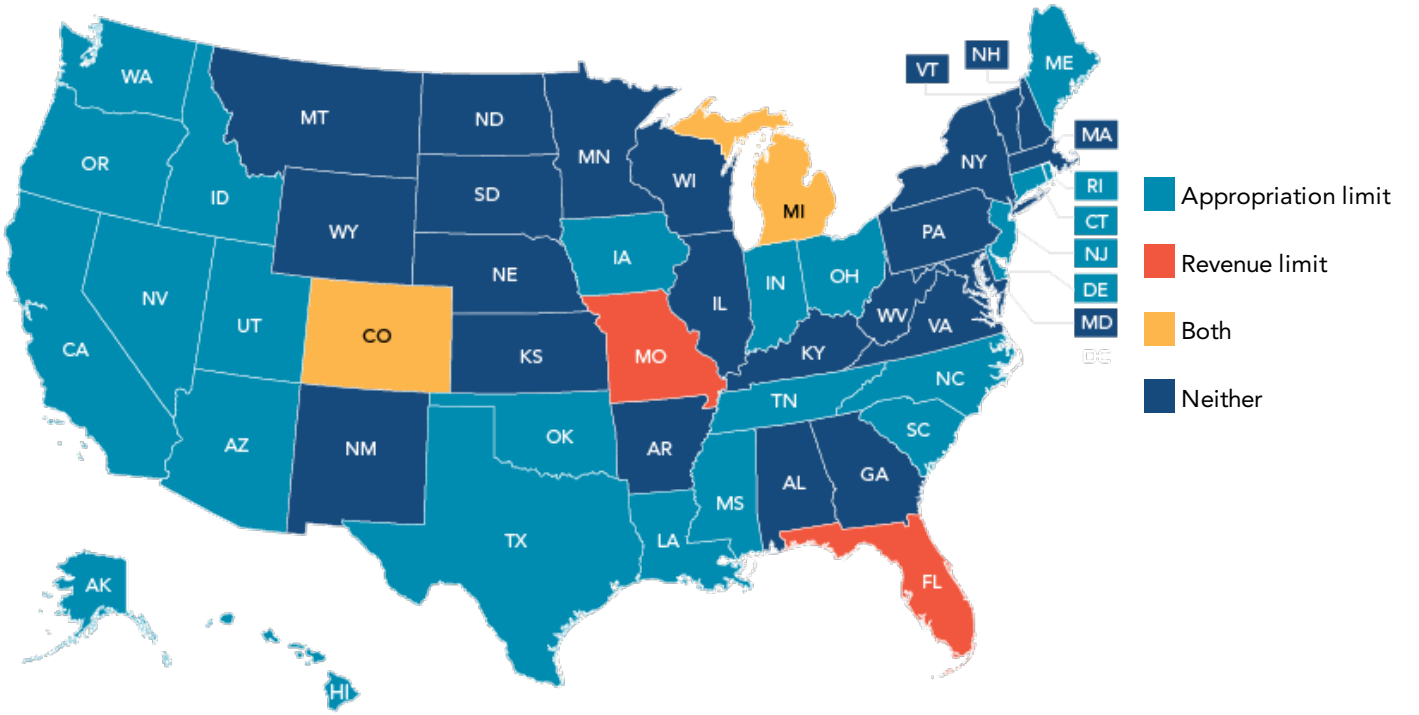
In general, TELs set in state constitutions are more difficult to change or override than statutory TELs. By the same token, TELs imposed directly by voters rather than legislators are more restrictive (New 2010).

Some TELs prohibit lawmakers from evading the limit through unfunded mandates or transfers of program responsibility to local governments, but more often, the measure of a TEL's stringency is the ability of the governor and legislature to override the cap. Several states have what at first glance appear to be restrictive TELs, but those states only require simple legislative majorities to override, which is the same threshold for approving budgets. Six states—Alaska, California, Colorado, Missouri, South Carolina, and Texas—require popular votes to exceed the limits (figure 1).

FIGURE 1

Tax and Expenditure Limits by State

2015



Source: NASBO, 2015.
Notes: Delaware has been added and Illinois removed from source data. Alaska and Hawaii are not drawn to size.

There are also 14 states with legislative supermajority (usually three-fifths or two-thirds of the legislature) and voter approval requirements for new taxes. These requirements may pertain to all taxes or only to specific revenue sources, such as corporate or sales taxes. The most stringent revenue limits require that surplus revenues go back to tax-payers as rebates or be sequestered in rainy day funds. Oregon's "Kicker" rebate and Colorado's Taxpayer Bill of Rights (see box) are examples. Thirteen states require su-permajorities to increase taxes; Colorado requires a voter referendum.

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 constraint or the other. Poterba and Rueben (1999) found that TELs affect the costs of state borrowing in two ways: not surprisingly, spending limits lower the costs, and revenue limits increase them.

BACKGROUND

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 2½, were adopted through citizen initiatives, most state TELs originated in their legislatures. As of 2015, legislatures had enacted 17 TELs, nine were passed as voter initiatives and two emerged from constitutional conventions.

Evidence on whether TELs limit state and local spending is mixed (Gordon 2008). Rue-ben (1996) found that specific details of the laws matter and that TELs requiring a legislative supermajority or popular vote to modify spending led to a 2 percent reduction in state general fund expenditures. However, those savings were offset in part by higher local spending. New (2010) found that TELs adopted through citizen referendum were more effective than those adopted by legislatures.

PROPERTY TAX LIMITS

Property tax limits constitute a special category because, in most cases, the limits are set by state governments but apply to local governments. Only four states—Connecticut, Hawaii, New Hampshire, and Vermont—do not limit property taxes. State restrictions can apply to the property, to the jurisdiction, or both. Rate limits impose maximum rates on jurisdictions (e.g., counties, municipalities, and school districts) and apply to properties. Limits on how much assessments can increase are typically applied to properties.

For example, Arizona limits combined state and local tax rates to a maximum of 1 percent; restricts governments' taxing authority to levy property taxes at 2 percent over the previous year; caps local government expenditure growth financed by property taxes to inflation and the growth in population; and limits residential property assessment to 10 percent growth.

Colorado's Taxpayer Bill of Rights (TABOR)

Colorado enacted a TABOR in 1992 that is arguably the nation's most restrictive TEL. The TABOR applies to all taxing districts in the state, and requires that voters directly approve all tax rate and property tax assessment increases as well as the imposition of new levies. The law also explicitly prohibits particular types of taxes.

The TABOR also 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. However, in November 2005, Colorado voters did agree to suspend the revenue cap for five years. (McGuire and Rueben 2006).

The State of State (and Local) Tax Policy

What are tax and expenditure limits?

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GLOSSARY

A

Accelerated depreciation: See depreciation.

Adjusted Gross Income (AGI): A measure of income used to determine a tax filing unit's tax liability (before subtracting personal exemptions and the standard or itemized deductions). AGI excludes certain types of income received (e.g., municipal bond interest, most Social Security income) or payments made (e.g., alimony paid, IRA deductions, moving expenses). (See also taxable income.)

Affordable Care Act (ACA): See Patient Protection and Affordable Care Act (PPACA).
After-tax income: Total income of an individual or corporation minus all federal, state, and local taxes (e.g., federal income tax, Social Security tax).

Alternative minimum tax (AMT): The individual alternative minimum tax is a supplemental income tax originally intended to ensure that high-income filers not take undue advantage of tax preferences to reduce or eliminate their tax liability. The most common "preference" items, however, are for state and local tax deductions, personal exemptions, and miscellaneous itemized deductions—not items normally thought of as preferences or shelters. The AMT exemption and tax bracket thresholds are indexed for inflation, protecting many taxpayers from the tax, but rising real incomes make more taxpayers subject to the AMT every year. There is also a corporate alternative minimum tax, but few companies are subject to it.

AMT patch: For many years following enactment of the 2001 tax cuts, lawmakers repeatedly—but only temporarily—raised the AMT's rate bracket thresholds and exemption to offset the effects of inflation. These ad hoc adjustments are sometimes referred to as the "patch," because it was a stopgap remedy for a basic design flaw—the fact that the AMT was not indexed for inflation, unlike most other income tax provisions. Patch legislation also typically extended a temporary provision allowing AMT taxpayers the full benefit of personal tax credits, such as the child and dependent care tax credit. The American Taxpayer Relief Act of 2012 eliminated the need for the patch by permanently raising the AMT exemption amount and indexing it, the AMT exemption phaseout threshold, and AMT tax brackets for inflation beginning in 2013. (See also indexation of the tax system.)

American Taxpayer Relief Act of 2012 (ATRA): Permanently extended most provisions of the 2001 and 2003 tax acts (EGTRRA and JGTRRA) but generally allowed both acts to expire for taxpayers with the highest incomes. In particular, the act maintained most reduced tax rates, expansion of the child tax credit and EITC, and the American Opportunity credit for higher education. It also made permanent reductions to the AMT and the estate tax.

Appropriation: Money a state or federal legislature designates for a specific purpose. Federal appropriations are paid for by the US Department of the Treasury.

Automatic stabilizers: Features of government tax and transfer systems that temper the economy when it overheats and provide economic stimulus when the economy slumps, without direct intervention by policymakers.

GLOSSARY

Average effective tax rate (ETR): A widely used measure of tax burdens, equal to tax paid divided by some measure of income. ETRs may be calculated with respect to a single tax, such as the individual income tax, or with respect to a combination of taxes (e.g., the total of individual and corporate income taxes, payroll taxes, excise taxes, and estate taxes). Furthermore, ETRs can differ, depending on whether taxes are assigned based on statutory incidence (who remits the tax to the government) or on economic incidence (who bears the actual economic cost of the tax). Note that all Tax Policy Center estimates of ETRs are based on economic incidence. (See also tax incidence.)

B

Balanced budget: A budget in which revenues equal outlays. A balanced budget has neither a deficit nor a surplus.

Base broadening: A term applied to efforts to expand the tax base, usually by eliminating deductions, exclusions, and other preferences from the tax base. A broader base allows more revenue to be raised without increasing tax rates, or for rates to be cut without sacrificing revenues.

Bracket creep: The movement of taxpayers into higher tax brackets caused by inflation. Under a progressive tax system, rising nominal income can move taxpayers into higher tax brackets, even if their real income (after adjusting for inflation) remains constant. Congress indexed tax rate schedules for inflation in the early 1980s to prevent general increases in the price level from causing bracket creep. (See price indexing.)

Budget baseline: The baseline is the level of revenue (or spending) expected under a given set of assumptions. Traditionally, Congress and the administration have used a "current law baseline" that assumes that discretionary spending grows at the rate of inflation and mandatory spending and tax revenues are determined by current law. In particular, this approach assumes that temporary tax provisions will expire as scheduled. An alternative is a "current policy baseline," which assumes that temporary tax cuts are extended indefinitely and that temporarily delayed provisions never take effect. The Obama administration used the latter baseline during the years when the temporary 2001-2003 tax cuts were in effect.

Budget resolution: A non-binding Congressional outline for federal spending and revenues for the next fiscal year, including targets for the subsequent four fiscal years. A budget resolution does not actually appropriate funds, but instead, sets goals and establishes tax and spending priorities. It may include budget reconciliation instructions.

Budget scoring: The process of estimating the budgetary effects of proposed changes in tax and expenditure policies and enacted legislation. The budget score represents the difference from baseline revenues or spending.

GLOSSARY

Bush tax cuts: A set of tax provisions that were originally enacted in the administration of President George W. Bush—mostly in 2001 and 2003. The first installment, the Economic Growth and Taxpayer Relief and Reconciliation Act of 2001 (EGTRRA), cut individual income tax rates, phased out the estate and gift tax, doubled the child tax credit, provided marriage penalty relief, expanded retirement tax incentives, and temporarily raised the threshold for taxation under the individual alternative minimum tax (AMT). The provisions of EGTRRA phased in slowly and al of them were set to expire at the end of 2010. The Jobs and Growth and Taxpayer Relief and Reconciliation Act of 2003 sped up many of the 2001 tax cuts, added cuts in the tax rates on long-term capital gains and dividends, and again temporarily patched the AMT, but preserved the 2010 expiration date. In succeeding years, Congress regularly adjusted AMT parameters to limit the impact of the alternative tax. In 2006, the Pension Protection Act made the retirement savings provisions of EGTRRA permanent and In 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act extended the Bush tax cuts through 2012 (along with several new tax cuts created by the American Recovery and Reinvestment Tax Act of 2009). Finally, the American Taxpayer Relief Act of 2012 made the Bush tax cuts permanent for all but the highest-income taxpayers. (See also AMT patch.)

C

Capital cost recovery: Income tax features intended to allow businesses to deduct over time the costs of tangible capital assets that are used to produce income. It is similar to a depreciation allowance, except that "depreciation" in principle relates the timing of the deductions to changes in asset value over time. (See depreciation.)

Capital gains: The difference between the sale price and purchase price of capital assets net of brokers' fees and other costs. Capital gains are generally taxable upon sale (or "realization"). Long-term gains, those realized after a year or longer, face lower tax rates (no more than 20 percent) than short-term gains, which are taxed the same as earned income. High-income taxpayers must also pay the Affordable Care Act's net investment income tax, a 3.8 percent tax on capital gains and other investment income above specified thresholds. Taxpayers can deduct up to $3,000 of net losses (losses in excess of gains) each year against other income; taxpayers can carry over losses above that amount and deduct them from future gains.

Charitable deductions: Deductions allowed for gifts to charity. Subject to certain limits, individual taxpayers who itemize deductions and corporations are allowed to deduct gifts to charitable and certain other nonprofit organizations. Among other reasons, the deduction is intended to subsidize the activities of private organizations that provide viable alternatives to direct government programs. (See itemized deductions.)

Child and dependent care tax credit (CDCTC): A tax credit based on eligible child care expenses incurred by taxpayers who are employed or in school. The credit varies with the expenses incurred, the number of eligible children, and the taxpayer's AGI. A separate exclusion is available for some employer-provided child care.

GLOSSARY

Child tax credit (CTC): A $1,000 tax credit for each of a family's children under age 17. The credit is partially refundable for filers with earnings over a $3,000 threshold—the refundable portion is limited to 15 percent of earnings above the threshold. (See refundable tax credit.)
Circuit-breakers: Mechanisms that provide relief for an individual's property tax obligation on the basis of the person's age, income level, or disability.

Congressional Budget Office (CBO): A nonpartisan, congressional agency that gives Congress budget and economic analyses and information. CBO was established by the Congressional Budget and Impoundment Act of 1974 to provide Congress with its own agency to project and evaluate federal budget issues.

Consumer price index: A measure of the average level of prices, inclusive of sales and excise taxes, faced by urban households for a given "market basket" of consumer goods and services.
Consumption tax: Tax on goods or services. In the United States, most consumption taxes are levied by states and local governments (as retail sales taxes), although the federal government does levy some selective consumption taxes, called "excise taxes," on items such as alcohol, tobacco products, and gasoline. The most common consumption tax overall is the value-added tax (VAT), used by virtually all developed countries but not by the US.

Corporate income tax: A tax levied on corporate profits. A corporation's taxable income is its total receipts minus allowable expenses and capital depreciation. The top corporate income tax rate in the US is 35 percent, higher than that in any other developed country.

D

Debt held by the public: The portion of the national debt held by entities other than the federal government. Investors holding this debt include US citizens, state and local governments, the Federal Reserve, domestic private investors such as banks, and international investors such as foreign nations.

Debt service: The amount needed to repay interest and principal on a debt over a period of time. For an individual, this might be the amount they owe on student loans or a mortgage. For the federal government, debt service is the interest paid on the national debt.

Deduction: A reduction in taxable income for certain expenses. Some deductions such as that for contributions to an Individual Retirement Account (IRA) reduce AGI. Most deductions, such as those for home mortgage interest and state and local taxes, are only available to those who itemize deductions. About 70 percent of taxpayers choose not to itemize and instead claim the standard deduction because it provides a greater tax benefit. Because tax rates increase with taxable income, a dollar of deductions generally benefits a high-income taxpayer more than a low-income taxpayer. Deductions cannot reduce taxable income below zero.

GLOSSARY

Deficit: The difference between what the governments takes in (receipts) and spends (outlays) during a year, typically either a fiscal year (October-September for the US government) or a calendar year.

Defined benefit pension plan (DB plan): A retirement plan that guarantees a specified retirement payment beginning at a certain age and after a specified period of service. Contributions to and earnings in DB plans are exempt from both income and payroll taxes, and withdrawals are fully subject to federal income tax.

Defined contribution retirement plan (DC plan): A retirement program in which each employee has an individual account that accumulates employee contributions, employer contributions, and investment earnings. Contributions to DC plans and any increase in value are generally not included in the taxable income of beneficiaries. Employer contributions are also exempt from payroll tax. Withdrawals are fully taxable.

Dependent: An individual supported by a tax filer for more than half of a calendar year. Federal tax law stipulates five tests to determine whether a filer may claim someone as a dependent and thus qualify for an exemption: a relationship test, a joint return test, a citizen-or-resident test, an income test, and a support test. In 2017, a tax filer can reduce taxable income by $4,050 for each dependent exemption.

Depreciation: A measurement of the declining value of assets over time because of physical deterioration or obsolescence. The actual rate at which an asset's value falls is called economic depreciation, which depends on wear and tear and the rate of technological obsolescence. . In practice, tax depreciation is calculated by a schedule of deductions, usually over the asset's "useful life" specified in the tax code through which the full cost of an asset can be written off. Accelerated depreciation refers to a depreciation schedule that allows larger deductions in early years than would be expected due to economic depreciation. (See also Expensing.)

Discretionary spending: Spending decided upon by Congress through the annual appropriations process.

Distortion: The economic cost of changes in behavior due to taxes, government benefits, monopolies, and other forces that interfere with the otherwise-efficient operation of a market economy. For example, employees might choose to work fewer hours because taxes reduce their after-tax wage.

Distribution table: A table that details how a proposal or policy affects the distribution of tax burdens across income categories, demographic groups, or sets of taxpayers defined by other characteristics. Alternative measures assess different aspects of distributional effects (see Measuring the Distribution of Tax Changes).

Dividends: Profits distributed by a corporation to its shareholders. Under 2003 tax law, most dividends are taxed at the same lower tax rates that apply to long-term capital gains.

GLOSSARY

Double taxation of dividends: Most tax systems that have both corporate and individual income taxes levy tax on corporate profits twice, once at the corporate level and again at the individual level when shareholders receive profits in the form of dividends or capital gains. The reduced tax rates on capital gains and dividends are intended in part as an offset to double taxation. Other more sweeping reform options would address double taxation by allowing shareholders credits against personal taxes for tax levied at the corporate level (an "imputation system") or by passing corporate profits through to shareholders, similar to the tax treatment of partnerships and S-corporations ("corporate tax integration").

Dynamic analysis: An approach to calculating how a tax proposal would affect the economy in the short and long run by determining the policy's macroeconomic effects. Unlike conventional ("static") analysis, which holds economic inputs and outputs constant, dynamic analysis predicts how a policy would affect macroeconomic factors, such as consumption, investment, saving, and labor supply, and uses those factor changes to forecast GDP and government revenues over a period of time. Dynamic analysis can also be used for proposals affecting government spending and regulation.

Dynamic modeling: Computer simulation of how tax policy or tax reform affects the economy taking into account how individuals, households, or firms alter their work, saving, investment, or consumption behavior, and how those effects feed back to affect tax revenues.
Dynamic scoring: See dynamic analysis.

E

Earned income tax credit (EITC): A refundable tax credit that supplements the earnings of low-income workers. The credit is a fixed percentage of earnings up to a base level, remains constant over a range above the base level (the "plateau"), and then phases out as income rises further. Those income ranges depend on both the taxpayer's filing status and number of children in the taxpayer's family. In contrast, the credit rate depends only on the number of children. Married couples with three or more children receive the largest credit, a maximum of $ 6,318 in 2017. Childless workers get the smallest credit, no more than $510 in 2017. Originally enacted in 1975, the EITC is now the largest federal means-tested cash transfer program.

Economic Growth and Taxpayer Relief and Reconciliation Act of 2001 (EGTRRA): A tax bill passed under the presidency of George W. Bush (and therefore often referred to as the "Bush tax cut") that reduced most tax rates, increased the child tax credit and made it partially refundable, expanded tax-free retirement savings, reduced marriage penalties, increased the child and dependent care tax credit, and phased out the estate tax. Most provisions were scheduled to phase in slowly between 2001 and 2010, and then expire at the start of 2011. JGTRRA accelerated some of the EGTRRA tax cuts and added others.

GLOSSARY

Economic income: A very broad income concept that includes cash income from all sources, fringe benefits, net realized capital gains, both cash and in-kind transfers, the employer's share of payroll taxes, and corporate income tax liability. The Treasury Department's Office of Tax Analysis developed a similar measure in the 1980s and used it for distribution tables until 2000.

Economic Recovery Tax Act (ERTA): Tax legislation enacted in 1981 (and often referred to as the "Reagan tax cut") that significantly reduced income taxes on individuals and businesses. The Tax Equity and Fiscal Responsibility Act (TEFRA) scaled back the cuts in 1982.

EGTRRA: See Economic Growth and Taxpayer Relief and Reconciliation Act of 2001.

Employer-sponsored health insurance: Health insurance offered by an employer to some or all employees. Employer contributions to health insurance plans are exempt from both income and payroll taxes. Economists believe that workers accept lower wages in exchange for the valuable tax-free fringe benefit. The exclusion from tax of employer-sponsored health insurance is the single biggest tax expenditure.

Empowerment zone: A rural and urban geographic area of economic distress eligible for special grants, business training, improved access to capital, tax benefits, and regulatory relief aimed at encouraging economic development and greater opportunity.

Enterprise zone: A geographically targeted tax, expenditure, and regulatory inducement used by state and local governments since the early 1980s and by the federal government since 1993. While they differ in their specifics, all the programs provide development incentives in an attempt to encourage private investment and increase employment opportunities.
Entitlements: Payments to individuals, governments, or businesses which, under law, must be made to all those eligible and for which funds do not have to be appropriated in advance. Major entitlement programs include Social Security, Medicare, Medicaid, and Temporary Assistance to Needy Families (TANF).

ERTA: See Economic Recovery Tax Act.

Estate tax: A tax levied on a person's estate at the time of his or her death. The federal estate tax applies only to large estates, those worth over $5.49 million for people dying in 2017 ($10.98 million for married couples). No tax is owed on transfers to spouses or to charities and special provisions apply to farms and small businesses. (See also Gift Tax and Inheritance Tax.)
Excise tax: A tax on specific goods and services, levied at federal, state, and local levels. The most common excise taxes are on gasoline, alcohol, and tobacco products.

Expenditure: The purchase of a good or service.

Expensing: Allow businesses to immediately deduct the entire cost of a capital asset, rather than claiming depreciation deductions over the useful life of the asset. (See also Depreciation.)

GLOSSARY

Extenders: Temporary tax provisions that will expire if Congress does not act to extend them.

F

Federal poverty levels: See Poverty levels.

Federal fiscal year (FY): See Fiscal year.

Federal Reserve: The central bank of the United States that controls monetary policy. The Federal Reserve System of the United States, also referred to as the Fed, is made up of 12 Federal Reserve Banks throughout the country and is headed by a Board of Governors. The Fed controls monetary policy by making open-market sales or purchases of government bonds and Treasury bills.

Filing status: Tax filers fall into one of five categories, depending on their marital status and family structure. A single person without children files as a single; a single person with dependents who maintains her own home files as a head of household; a married couple, with or without children, files either as married filing joint or married filing separate; and a recent widow(er) may file as a qualifying widow(er), which is the same, in effect, as married filing joint. The standard deductions, bracket widths, and qualification criteria for certain credits and deductions vary by filing status.

Fiscal policy: The way in which the federal government can affect the economy through tax and spending policies. Fiscal policy can boost economic activity, at least in the short run, through tax cuts and increases in spending. Fiscal policy can slow down the economy through tax increases or spending cuts.

Fiscal year: The government's accounting period designated by the calendar year in which it ends. The federal government's fiscal year begins on October 1 and ends on September 30.

Flat tax: A proposal for tax reform that would replace the income tax system with a single-rate (or flat-rate) tax on businesses and individuals, after an exempt amount. Many flat tax proposals are designed to be consumption rather than income taxes (see VAT), many would retain politically sensitive deductions such as for mortgage interest payments, and most are really not "flat" because they grant an exemption at least for the first dollars of earnings.

Foreign tax credit: A credit that allows U.S. residents to subtract foreign income taxes paid from the U.S. income tax due on income earned abroad.

G

Gift tax: A tax levied on gifts in excess of a specified threshold. In 2017, no tax is levied on annual gifts of up to $14,000 per recipient; gifts in excess of the limit are taxable but no tax is due until lifetime taxable gifts total more than $5.49 million. Any tax still due must be remitted when the donor dies and is incorporated into the decedent's estate tax. (See also Estate tax.)

GLOSSARY

Gini coefficient: A summary measure of how unequal is the distribution of income (or wealth or other quantity) across a given population. It ranges from 0 (perfect equality) to 1 (perfect inequality); higher values thus indicate greater inequality. The coefficient is useful for comparing levels of inequality over time or across populations. Note, however, that two populations may have the same Gini coefficient and thus the same level of inequality overall, yet have differently shaped income distributions.

Gramm-Rudman-Hollings law: A law enacted in 1985 requiring that budget deficits be brought down to specified amounts and the budget be balanced by 1991; failure to meet those goals would trigger automatic spending cuts. The law was replaced in 1990 with specific deficit reduction targets (and pay-as-you-go rules) unrelated to actual size of the deficit, as it varied with economic conditions. (See also Pay-as-you-go and caps.)

Gross domestic product (GDP): The total value of goods and services produced by the economy, the sum of aggregate consumption, investment, government purchases, and exports, less the value of imports.

H

Health savings account (HSA): A special tax-favored account for deposits made to cover current and future health care expenses paid by the individual. Like defined contribution retirement plans, contributions to HSAs and any earnings are generally deductible (or excluded from income if made by an employer). Unlike DC plans, withdrawals from the account are also tax-free as long as they are used to pay for medical expenses. Enacted in 2003 as part of legislation providing drug benefits under Medicare, the tax preference is only available if the individual purchases a high-deductible health insurance policy.

Highway trust fund: A federal trust fund created in 1956 to finance highway construction and certain other federal spending on transportation. The fund's revenues and outlays are segregated from the rest of the federal budget.

Horizontal equity: (See also Vertical equity.) The concept that people of equal well-being should have the same tax burden.

Human capital: Knowledge and skills that people acquire through education, training, and experience.

I

Income: The amount of wages, interest, dividends, business income, transfer payments, and other resources that an individual or household receives that can be used to purchase goods and services or be saved for future purchases.

GLOSSARY

Individual income tax: A tax on the income of an individual or household. In the US, a minimum level of income is exempt from tax, and rates are progressive. Many spending-like programs ("tax expenditures") are administered through the income tax.

Indexation of the tax system: Annual adjustments to various parameters in the tax code to account for inflation and prevent bracket creep. Since 1981, many features of the federal individual income tax, including personal exemptions and tax brackets, have been automatically indexed for inflation based on changes in the Consumer Price Index. For instance, with 5 percent inflation, a personal exemption of $1,000 would be raised to $1,050. More broadly, the term applies to all efforts to adjust measures of income to account for the effects of price inflation.

Inheritance Tax: A tax imposed on the amount of gifts and bequests a taxpayer receives from a person who dies. Currently the United States has no federal inheritance tax, but several states do. Inheritance tax rates can differ, depending on the relationship of an heir to the decedent, with the lowest rates applying to closer relatives such as spouses and children. (See also Estate Tax and Gift Tax.)

Intragovernmental debt: The amount one part of the federal government owes to another part of the federal government. This money is typically held in trust funds such as those for Social Security and Medicare.

IRA (Individual Retirement Account): Retirement accounts funded by individuals through their own contributions or by rolling over benefits earned under an employee-sponsored plan. An IRA is a kind of defined contribution retirement account. In traditional IRAs, contributions and earnings are tax-free, but withdrawals are taxable. In Roth IRAs, contributions are not deductible, but earnings and withdrawals are exempt from income tax.

Itemized deductions: Particular kinds of expenses that taxpayers may use to reduce their taxable income. The most common itemized deductions are for state and local taxes, mortgage interest payments, charitable contributions, medical expenses larger than 10 percent of AGI, and certain miscellaneous expenses. Individuals may opt to deduct these expenses or claim a standard deduction.

J

JGTRRA: See The Jobs and Growth Tax Relief Reconciliation Act of 2003.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA): The 2003 tax act that accelerated the phase-in of tax rate reductions scheduled under EGTRRA, reduced the taxation of capital gains and dividends, accelerated increases in the child credit amount, and temporarily raised the exemption for the alternative minimum tax (AMT). Most provisions were set to expire at the end of 2010, but were first extended through 2012 and then generally made permanent for all but high-income taxpayers by the American Taxpayer Relief Act of 2012. (See also Bush tax cuts and American Taxpayer Relief Act.)

GLOSSARY

Joint Committee on Taxation: A nonpartisan committee of the United States Congress charged with assisting Members of Congress on tax legislation and related issues. The committee helps draft legislative proposals, estimates the revenue effects of all tax legislation considered by the Congress, and examines various aspects of US federal taxes.

L

Low-income housing credit: A tax credit given to investors for the costs of constructing and rehabilitating low-income housing. The credit is intended to encourage the acquisition, construction, and/or rehabilitation of housing for low-income families. Credits are allocated to state housing agencies based on state population. The agencies select qualifying projects and authorize credits subject to statutory limits.

M

Mandatory spending: Expenditures on federal programs that are required by the statutory structure of the program, rather than by an annual appropriation. Examples are Social Security and Medicare.

Marginal tax rate: The additional tax liability due on an additional dollar of income. It is a measure of the effect of the tax system on incentives to work, save, and shelter income from tax. Provisions such as the phaseout of tax credits can cause marginal tax rates to differ from statutory tax rates.

Marriage bonus: The reduction in tax that some married couples owe because they must file as a couple rather than separately. Marriage bonuses result from the combination of treating a family as a single tax unit and progressive tax rates. In general, couples in which spouses have quite different incomes receive marriage bonuses. (See also Marriage penalty.)

Marriage penalty: The additional tax that some married couples pay because they must file as a couple rather than separately. Marriage penalties result from the combination of treating a family as a single tax unit and progressive tax rates. In general, couples in which spouses have similar incomes incur marriage penalties. (See also Marriage bonus.)

Medicaid: A federal entitlement program that reimburses states for a portion of the costs associated with providing acute and long-term care services to certain low-income individuals. States determine which services and categories of people, beyond the minimum required by federal law, to cover. States also establish payment rates for providers and administer the program.

Medicare Part A: The part of Medicare that covers hospital services, skilled nursing facility services, and some home health care. Anyone over age 65 who is eligible for Social Security and persons under age 65 who have received Social Security disability payments for two years are eligible. Participants pay no premiums for Part A coverage. (See also Medicare Part B and Medicare Part D.)

GLOSSARY

Medicare Part B: Supplementary medical insurance for Medicare beneficiaries; provides physician services and other ambulatory care (such as outpatient hospital services and tests). Beneficiaries must pay a premium to join; premiums, which are higher for high-income enrollees, cover about one-fourth program costs. All persons over the age of 65 and other Medicare beneficiaries can enroll. (See also Medicare Part A and Medicare Part D.)

Medicare Part D: Also called the "Medicare prescription drug benefit," Part D provides Medicare beneficiaries with supplementary medical insurance for prescription drugs. Enrollees pay an additional premium for Part D coverage. (See also Medicare Part A and Medicare Part B.)

Monetary policy: A set of actions taken by the Federal Reserve (or Fed) to influence the economy. Monetary policy can be used to control inflation, stimulate growth, or slow down the economy. The Fed influences the economy by making open-market sales or purchases of government bonds and Treasury bills. The rate at which the Fed sells or purchases government bonds determines the federal funds rate, or the rate at which banks can borrow funds from one another overnight.

Moral hazard: The incentive created by insurance (explicit or implicit) to engage in behaviors that raise the expected cost of insurance. The moral aspect refers to the observation that unscrupulous people covered by fire insurance were sometimes tempted to engage in arson. However, less insidious behavior, such as using more health services when they are covered by insurance, is also covered by the term.

N

National debt: The cumulative amount that the federal government owes its creditors. Total US federal debt is the sum of debt held by the public and intragovernmental debt, and is approximately equal to deficits accumulated over the years.

Nominal income: A measure of income that is not adjusted for inflation. That is, nominal income is expressed in current dollars. (See also real income.)

Non-filer: A person or household who does not file an individual income tax return. Most non-filers do not work; many are elderly. Others simply fail to comply with the legal requirement that they file annual tax returns.

O

OASDI (Old Age, Survivors, and Disability Insurance): The Social Security programs that pay monthly benefits to retired workers and their spouses and children, to survivors of deceased workers, and to disabled workers and their spouses and children.

GLOSSARY

Off-budget: Federal government expenditures on certain programs, agencies, and government sponsored enterprises that are accounted for separately in the budget to prevent spending changes or avoid a conflict of interest. Examples "off-budget" programs include Social Security and the Post Office. The Federal Reserve is an "off-budget" government agency in order to maintain its autonomy when making policy decisions.

Office of Management and Budget (OMB): An office of the executive branch that develops the president's budget and evaluates the effectiveness of the executive branch's programs and policies.

On-budget: Government programs that are generally subject to annual appropriations, and therefore susceptible to spending cuts or increases.

The Omnibus Reconciliation Act of 1987: Legislation that attempted to decrease the budget deficit through tax increases and expenditure decreases.

The Omnibus Budget and Reconciliation Act of 1990 (OBRA90): This act increased excise and payroll taxes, added a 31 percent income tax bracket, and introduced temporary high-income phase-outs for personal exemptions and itemized deductions. OBRA93 made these changes permanent.

The Omnibus Budget and Reconciliation Act of 1993 (OBRA93): This act introduced 36 percent and 39.6 percent income tax brackets, repealed the wage cap on Medicare payroll taxes, increased the portion of Social Security benefits subject to income taxation for those with higher incomes, made more workers with children eligible for the Earned Income Tax Credit and increased their benefits, and made permanent the temporary high-income phase-outs of the personal exemption and itemized deductions. Overall, the bill was focused on deficit reduction.

Out year: In budget parlance, a future year beyond the period over which budget costs are tallied (in recent years, after a five5- or ten10-year period over which costs are estimated).

Outlay: The amount of federal spending on goods and services. (See also Expenditures.)

P

Patient Protection and Affordable Care Act (PPACA): Also known as the Affordable Care Act (ACA), the act included a variety of health-related provisions that extended health insurance coverage to many uninsured Americans, implemented measures designed to reduce health care costs, imposed requirements on health providers and insurance companies, and levied a broad range of taxes to help pay for expanded healthcare.

GLOSSARY

Pay-as-you-go system: A retirement system in which benefits for current retirees are funded by taxes on today's workers in return for the implicit promise that those workers will receive retirement benefits funded by future workers. Social Security operates largely on this system.

Pay-as-you-go and caps: As part of the 1990 Budget Enforcement Act, spending subject to appropriation was made subject to a separate series of annual caps. Pay-as-you-go rules (often called PAYGO) covered the rest of the budget: changes to mandatory spending and revenues could not together increase the deficit in any bill when pay-as-you-go rules were enforced.

PAYGO: See Pay-as-you-go and caps.

Payroll taxes: Taxes imposed on employers, employees, or both that are levied on some or all of workers' earnings. Employers and employees each pay Social Security taxes equal to 6.2 percent of all employee earnings up to a cap ($127,200 for 2017 and indexed for wage growth) and Medicare taxes of 1.45 percent on all earnings with no cap. Those taxes are referred to by the names of their authorizing acts: FICA (Federal Insurance Contributions Act) or SECA (Self-Employment Contributions Act), depending on the worker's employment status. Employers also pay State and Federal Unemployment Taxes (SUTA and FUTA) that cover the costs of unemployment insurance.

Personal exemption: A per-person amount of income that is shielded from income tax. In calculating taxable income, tax filers may subtract the value of the personal exemption times the number of people in the tax unit. The personal exemption—$4,050 in 2017—is indexed for inflation to maintain its real value over time.

Poverty guidelines: Income levels used to determine eligibility for participation in means-tested federal programs. The guidelines equal a base amount for each household plus a constant additional amount for each household member. The guidelines are indexed annually to the Consumer Price Index. (See also poverty levels.)

Poverty levels: (Also called "poverty thresholds.") The level of pre-tax cash income below which a family is considered to be officially "poor." Thresholds vary by family size, age of head, and number of children. When established in 1965, the thresholds were set at three times the cost of a minimally adequate diet and indexed annually for changes in the price of food. The basis for indexing changed to the Consumer Price Index for all goods and services in 1969. (See also poverty guidelines.)

Price indexing: (See also Wage indexing.). Adjusting monetary values by the change over time in prices. For example, many parameters in the federal individual income tax system are price-indexed annually. A prominent proposal to reform Social Security would price-index earnings to compute benefits, instead of the current wage indexing.

Progressive tax: A tax that claims a larger percentage of the income of higher-income households than from lower-income households. (See also regressive tax.)

GLOSSARY

Progressivity: A measure of how tax burdens increase with income. A progressive tax claims a proportionately larger share of income from higher-income than from lower-income taxpayers. Conversely, a regressive tax levies a larger share of income from lower-income households than from higher-income ones. Taxes that claim the same percentage of income from all taxpayers are termed "proportional."

Property tax: A tax based on the value of property owned by an individual or household. In the United States, most property taxes are levied locally.

Public debt: See "debt held by the public."

R

Real income: The value of income after accounting for inflation. Real income is typically converted in terms of a particular year's prices—for example, a table may show income in 2010 dollars, meaning that the incomes are shown in terms of purchasing power in 2010. (See also nominal income.)

Receipts: *Government revenue from taxes, fees, fines, and miscellaneous other sources.*
Reconciliation: A process created by the Congressional Budget Act of 1974, which allows for legislation to be fast-tracked for approval. If Congress opts to go through the "reconciliation" process, the House and Senate must set spending and tax targets. In recent years, the reconciliation process has been used to tack pieces of legislation onto the year-end Omnibus Spending Bill.

Refund anticipation loan: An immediate cash loan from a private lender, typically a commercial tax preparer, backed the by the anticipated tax refund claimed on the borrower's tax return.
Refundable tax credit: A tax credit that is payable even when it exceeds an individual's tax liability. Tax credits generally may be used only to reduce positive tax liability, and are therefore limited to the amount of tax the individual otherwise would owe. Unlike other tax credits, the refundable portion of a tax credit is scored as an outlay in government budget accounts—that is, it is treated the same as direct spending. (See, for example, earned income tax credit.)

Regressive tax: A tax that claims a larger percentage of the income of lower-income households than of higher-income households. (See also progressive tax.)

Revenue: Federal government revenue consists of taxes, mandatory fees, licenses, fines, and Federal Reserve earnings.

Revenue-neutral: A term applied to tax proposals in which provisions that raise revenues offset provisions that lose revenues so the proposal has no net effect on revenue.

GLOSSARY

S

SSDI (Social Security Disability Insurance): Social insurance that provides benefits to disabled individuals who have the required years of work covered by Social Ssecurity and can no longer work. (See also OASDI.)

SSI (Supplemental Security Income): Provides a floor of protection as cash for those who become disabled or reach age 65 and have very low incomes and assets.

Stagflation: The combination of stagnant growth and high inflation, a situation that occurred in the United States during the 1970s.

Standard deduction: A deduction that taxpayers may claim on their tax returns in lieu of itemizing deductions such as charitable contributions, mortgage interest, or state and local taxes. Typically, taxpayers with modest deductible amounts that could be itemized choose to take the standard deduction. Single filers, heads of household, and married couples filing jointly have different standard deductions. Roughly two-thirds of tax filers claim a standard deduction. (See also itemized deductions.)

Stimulus: An effort to increase growth in an economy during a recession by using monetary policy, fiscal policy, or both. Fiscal policy uses tax cuts and increased government spending to boost economic growth. Monetary policy can also stimulate economic growth by reducing interest rates through purchases of government bonds.

Sunset: Provision of a tax act that terminates or repeals other parts of the act on a certain date unless legislation is passed to extend them.

T

Tax incidence: A measure of the actual burden of a tax. Tax incidence may deviate from statutory tax liability because the imposition of a tax may change pre-tax prices. For example, retailers remit sales taxes, but those taxes raise the prices faced by consumers, who ultimately bear much of the burden of the tax.

Taxable income: The final income amount used to calculate tax liability. Taxable income equals adjusted gross income (AGI) less personal exemptions and the standard or itemized deductions.

Tax-after-credits: A filer's calculated, final tax liability after all credits (e.g., the earned income tax credit, the child credit, the child and dependent care tax credit, and the foreign tax credit) have been applied. If this amount is less than taxes paid via withholding or estimated tax payments, the taxpayer receives the difference as a refund. If the amount exceeds taxes paid, the taxpayer must remit the difference as a final payment.

GLOSSARY

Tax burden: The total cost of taxation borne by a household or individual. The burden includes not only the costs of taxes paid directly but also those taxes paid indirectly through lower wages or a reduced return on an investment. For example, in addition to the employee portion of payroll taxes, a worker may also bear the employer's share in the form of lower compensation.

Tax credit: A reduction in tax liability for specific expenses such as for child care or retirement savings. Unlike deductions, which reduce taxable income, a tax credit reduces tax liability dollar for dollar. Nonrefundable credits may only offset positive tax liability; in contrast, if a refundable credit exceeds the taxpayer's tax liability, the taxpayer receives the excess as a refund. (See also refundable tax credit.)

Tax expenditure: A revenue loss attributable to a provision of federal tax laws that allows a special exclusion, exemption, or deduction from gross income or provides a special credit, preferential tax rate, or deferral of tax liability. Tax expenditures often result from tax provisions used to promote particular activities in place of direct subsidies.

Tax filing threshold: The level of income at which filing units of specific size and filing status first owe a tax before considering tax credits. The amount varies with filing status, allowable adjustments, deductions, and exemptions. Tax credits can further increase the amount of untaxed income.

Tax incidence: A measure of the actual burden of a tax. Tax incidence may deviate from statutory tax liability because the imposition of a tax may change pre-tax prices. For example, retailers remit sales taxes, but those taxes raise the prices faced by consumers, who ultimately bear much of the burden of the tax.

Tax liability: The amount of total taxes owed after application of all tax credits.

Tax preferences: Special provisions of tax laws that are designed to further policy objectives different from tax policy objectives. In the income tax, such provisions include special deductions and exclusions, special rates, and tax credits. For example, the deduction for home mortgage interest is intended to encourage home ownership, rather than to properly reflect ability to pay income tax.

Territorial system: An income tax that generally applies only to economic activity within a country. A territorial tax is intended to apply only to income earned by residents and businesses from activities within the country. In practice, to mitigate tax avoidance territorial systems do apply to income earned outside the country in certain circumstances.

TRA86 (Tax Reform Act of 1986): Revenue-neutral legislation passed in 1986 that simplified the tax code, lowered marginal tax rates, and closed corporate loopholes.

TRA97 (Taxpayer Relief Act of 1997): Tax legislation passed in 1997 that reduced capital gains tax rates, introduced the child credit, created education credits, raised the estate tax exemption level, created Roth IRAs, and increased the contribution limit for traditional IRAs.

GLOSSARY

U

Unemployment insurance (or Unemployment compensation): A government program that provides cash benefits to some jobless workers for limited periods. Supervised by the federal government, the state-run programs are funded by payroll taxes states impose on employers.

V

Value-added tax (VAT): A form of consumption tax collected from businesses based on the value each firm adds to a product (rather than, say, gross sales). VATs are almost universal outside the United States.

Vertical equity: A value judgment about whether the net tax burden on people at different levels of well-being is appropriate. (See also horizontal equity.)