Taxing the Wealthy

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Main Points

• Principles of taxation helpful but not definitive in defining appropriate policy.
  – Evidence needed. Value judgments required.

• Long-term revenue increases
  – Are feasible and desirable. Need not impinge on growth.

• Tax expenditure reform can raise significant revenue.
  – May raise rates, though, too.

• Small business income is less important than previously thought.
Goals and Principles of Tax Policy
Goals and Principles – I

Revenue – Neutral Tax Reform

• Equity
  – Horizontal equity
  – Vertical equity
  – Intergenerational equity

• Efficiency
  – Taxes should avoid distorting choices
  – Deadweight loss is proportional to the square of the tax rate
  – Tax externalities improve market efficiency

• Generally, these will dictate toward “broad base, low rates”
Goals and Principles – II
Adding revenue considerations

• Adequate revenue
  – Partly, this is intergenerational equity
  – Complicates equity/efficiency trade-offs
  – Does not reduce the importance of equity/efficiency trade-offs
    – As revenue requirements grow, it is even more important that a tax system be well-designed
Why Consider Long-Term Tax Increases?
Why Consider Long-Term Tax Increases?

• U.S. has the capacity to raise taxes.
  – Revenues are at a 60-year low relative to GDP. They will rise as the economy recovers but only to historical average levels.

• New taxes would reduce the extent of spending cuts required.
  – Increasing numbers of elderly, health care cost growth, interest payments will create increasing spending needs.

• Public opinion supports tax increases as part of a fiscal solution.

• Shared sacrifice
  – Spending cuts don’t get at the highest-income households. The only way to have “shared sacrifice” is to include tax changes that target high-income households.
“Starve the Beast” Doesn’t Work

• Effectiveness in containing spending
  – Holding taxes low in order to cut spending doesn’t work. Not raising taxes makes the cost of spending appear lower than it actually is. (Buchanan; Romer and Romer)

• Political sustainability
  – A stable decision will require both sides give up cherished positions. It is not stable to have fiscal discipline on the spending side but fiscal largesse (low taxes) on the other.
Taxes and Growth
Taxes and Growth

• Two effects of a tax hike
  – Direct effect on incentives and after-tax income (income and substitution effects): Can increase or decrease labor supply, saving, and investment, depending on the structure of the tax change.
  – Lower budget deficit (if spending is held constant) reduces national saving.

• The sign of the net effect on economic growth is ambiguous
Taxes and Growth
Income Tax Reform/
Tax Expenditures
# Largest Income Tax Expenditures

*(Billions of Dollars)* 

<table>
<thead>
<tr>
<th>Tax Expenditure</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health care exclusion</td>
<td>170.7</td>
</tr>
<tr>
<td>Mortgage interest deduction</td>
<td>86.9</td>
</tr>
<tr>
<td>401(k)-type plans</td>
<td>60.1</td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>76.3</td>
</tr>
<tr>
<td>Net imputed rental income</td>
<td>50.6</td>
</tr>
<tr>
<td>Capital gains</td>
<td>66.2</td>
</tr>
<tr>
<td>Employer pension contributions and earnings</td>
<td>44.5</td>
</tr>
<tr>
<td>State and local tax deduction</td>
<td>33.2</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>33.3</td>
</tr>
<tr>
<td>State and local bonds</td>
<td>29.1</td>
</tr>
</tbody>
</table>
# Revenue from Reform Options

<table>
<thead>
<tr>
<th>Policy Proposal</th>
<th>2015 Revenue as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) $50,000 cap on itemized deductions¹</td>
<td>0.34</td>
</tr>
<tr>
<td>a) Including charitable contributions</td>
<td></td>
</tr>
<tr>
<td>b) Excluding charitable contributions</td>
<td>0.22</td>
</tr>
<tr>
<td>2) Feldstein-MacGuineas 2% of AGI cap on the <em>tax value</em> of certain items² for high-income households (AGI above $200,000(s) / $250,000(m))</td>
<td>0.26</td>
</tr>
<tr>
<td>3) Tax capital gains and dividends as ordinary income³</td>
<td>0.42</td>
</tr>
</tbody>
</table>

1. TPC.
2. TPC. The items covered by the cap are itemized deductions, pre-tax employer and employee health insurance premiums, the child and dependent care credit and the general business credit. For credits, the tax value equals the credit. For deductions (or exclusions), the tax value equals the deduction (or exclusion) times the marginal tax rate.
3. OMB. This is a tax expenditure estimate for 2011, not a revenue estimate of changing the provision.
Distributional Effects of Policies to Limit High Income Tax Expenditures

Percent Decrease in After Tax Income

- Cap itemized deductions at $50,000
- Cap Itemized Deductions at $50,000, excluding Charitable Contributions
- Limit tax value of tax expenditures to 2 percent of AGI above threshold
- Tax Capital Gains and Dividends as Ordinary Income

Cash Income Percentile

0-20  20-40  40-60  60-80  80-90  90-95  95-99  Top 1%  All
Taxes and Small Business Income
## Distribution of Small Business Income (Treasury’s Broad Definition)

<table>
<thead>
<tr>
<th>AGI Level</th>
<th>Percent of All Tax Returns</th>
<th>Percent of Adjusted Gross Income</th>
<th>Percent with Small Business Income</th>
<th>Percent of AGI that is Small Business Income</th>
<th>Allocation of Small Business Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $200,000</td>
<td>96.8%</td>
<td>67.3%</td>
<td>12.8%</td>
<td>2.3%</td>
<td>35.6%</td>
</tr>
<tr>
<td>$200,000 - $1,000,000</td>
<td>2.9%</td>
<td>16.6%</td>
<td>48.4%</td>
<td>4.3%</td>
<td>46.5%</td>
</tr>
<tr>
<td>$1,000,000 +</td>
<td>0.3%</td>
<td>16.1%</td>
<td>69.6%</td>
<td>5.7%</td>
<td>17.8%</td>
</tr>
<tr>
<td>100.0%</td>
<td>100.0%</td>
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<td></td>
</tr>
</tbody>
</table>

# Administration Revenue Proposals

## Policy Proposal

<table>
<thead>
<tr>
<th>Proposal</th>
<th>2013-2022 budgetary effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raise top two tax rates</td>
<td>442</td>
</tr>
<tr>
<td>Tax dividends at ordinary rates</td>
<td>206</td>
</tr>
<tr>
<td>Increase capital gains rate</td>
<td>36</td>
</tr>
<tr>
<td>Reinstate Pease limitation</td>
<td>123</td>
</tr>
<tr>
<td>Reinstate personal exemption phase-out</td>
<td>42</td>
</tr>
<tr>
<td>Revert to 2009 estate and gift tax law</td>
<td>119</td>
</tr>
<tr>
<td>Limit itemized deduction and certain exclusions to 28 percent*</td>
<td>584</td>
</tr>
</tbody>
</table>

**Total** 1552

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* Budget of the United States.

* Limited items include itemized deductions, tax-exempt interest, health insurance, and employee contributions to retirement plans.
Conclusion

• Raising revenue is not a crazy idea
  – Can improve the equity of a fiscal solution
  – Can improve the effectiveness/enforcement of a fiscal solution
  – Can improve efficiency in some cases, do minimal harm in others
  – Can be used in part to simplify taxes, reduce rates
  – Deficit reduction effects would help long-term growth