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THE FAIRNESS ISSUE

We have met the special interests, and they is us.
with apologies to Walt Kelly.

One of the notable things in the development of the major tax bill last year was the relative quiet about its distribution of tax reductions. Sure, the issue was raised and the House Democrats tried to fashion a bill giving more relief to lower-income groups. But in contrast to earlier tax reform movements, equity of distribution was not a dominant issue. Most all of the debate centered on the size of tax reductions in relation to the budget and the extent to which marginal tax cuts would increase savings and investment. These matters hardly have been put to rest but now the "fairness" issue is coming to the front, too.

In recent weeks there has been a public outpouring about the equity of the tax system and increasingly sharp criticisms of the Economic Recovery Tax Act for favoring the rich and the corporate sector. For example, Citizens for Tax Justice has been circulating a slickly-written piece entitled, "The Reagan Tax Shift--A Report on the Economic Recovery Tax Act of 1981." Not surprisingly, this group finds nothing good to say about ERTA. It "showers tax reductions on the very highest income individuals and virtually wipes out the corporate income tax." Whereas this type of jab from the left drew only yawns in 1981, now it is being widely quoted in the press and in Congress.

Around April 15, of course, the tax system is never very popular. This year a combination of factors is raising the public ire to new heights.

- Disclosures that some firms have significantly reduced their corporate income tax liabilities through participation in the safe harbor leasing program set up by ERTA.

- The $75 per diem safe harbor that Congress voted itself last December.

- A spate of reports on the spread of the underground economy--working off the books to evade tax liabilities.

- There is also much concern about the gray area of tax shaving indulged in by all sorts of taxpayers--more questionable items in personal deductions, inflated valuations in tax shelter schemes, taking dependents as exemptions who may really be supporting themselves, and so on. We even have coined a new phrase--tax "avoision"--to describe the ongoing game of minimizing taxes by both legal and not-so-legal means.

- A widespread perception that the tax system has become hopelessly complicated infested with special breaks of particular benefit to upper income people who can afford tax accountants but generally not available to most salaried and hourly paid workers subject to withholding. It is widely assumed that ERTA made this situation more complicated and more unfair.

- Most important, the fact that presently we are scrounging around for new ways to raise taxes less than a year from the biggest tax cut in post-war history, and at the same time, are considering significant cuts in public expenditure programs that are said to affect lower income groups the most.

Response

The Administration and Republican leadership in the Senate have become extremely sensitive to the fairness issue. As soon as it became apparent that press stories about the safe harbor leasing program were not going away, the Administration decided to support a new and much tighter minimum tax on corporate income to ensure that major corporations paid some tax regardless of special tax provisions, including leasing (and not so incidentally to raise additional revenue in the process). Similarly, there is now a building movement to impose a surcharge on upper income individuals both to raise revenue and "balance" some of the budget cuts affecting lower income groups. Senate Majority Leader Howard Baker is leading the charge on this proposal, and it may yet get the Administration's blessing as a way to diffuse charges of favoritism to the wealthy while retaining the basic 5-10-10 rate cuts.

While the Administration repeatedly has stressed the need to stick to its program and policy decisions of ERTA, both the minimum tax and any surcharge would go in precisely opposite directions. Most of the impact of the minimum tax in the form proposed by the Administration would involve restrictions on the employment of the investment credit and net operating loss deductions in direct contrast to the investment incentives of ERTA. The minimum tax also would have a large impact on some industry sectors such as commercial banking, which received relatively little tax relief under ERTA and, as a sector at least, has not participated extensively in safe harbor leasing. Ironically, the minimum tax proposal has a very good chance of adoption in some form but has not called off the dogs on safe harbor leasing at all. If anything, the hue and cry to repeal or modify the leasing program is louder than ever.

As for a surcharge, any such tax would lock in on the present graduated rate structure. If confined to upper income brackets it would increase the progressivity of the structure and as not that many individual taxpayers would be involved, increase the chances of this becoming a permanent feature. A 4% surcharge on incomes above, say, $40,000, rumored to be the Senate preference, would not mean significant new revenue to reduce the budget deficit. But it would go 180^{o} against the policy thrust of ERTA and move the top rate back up to 52%. This, of course, is a far cry from the former 70%, but for the considerable number of taxpayers subject to the maximum tax of 50% on earned income in years prior to 1982 and who did not have significant investment income, a surcharge could mean an actual tax increase. And instead of the certainty of permanently lowered rates that was so important under ERTA, new questions would be raised as to future tax burdens--no help to savings and investment.

Another Look at ERTA

The individual tax reductions under ERTA have been criticized for giving away too much too soon, but at the same time for giving too much of the relief to the top half of the income scale. Meanwhile, according to critics such as Citizens for Tax Justice, middle and lower income groups will see the meager cuts they did get consumed by the bracket creep of inflation and Social Security tax increases.

There is, of course, a striking dichotomy in the arguments of those who claim that ERTA just gave away the store and will greatly aggravate the budget deficit, and those that say that the tax cuts weren't enough to keep up with inflation and Social Security burdens. Sometimes these are the same people. Their arguments could be rationalized perhaps by taking away all of the tax relief above the so-called "working classes" of $20,000-$50,000--which might raise some awkward questions of equity, too. In any event, the table below, prepared by Citizens for Tax Justice, reflects the now oft-heard criticism of the present program.

Average Total Net Tax Changes 1982, 1983, and 1984
Under 1981 Act, After Bracket Creep and Social Security Increases

Income (000)	1982, 1983, & 1984 Net Change	Percent Net Change
Under $10	$ + 331	+24%
$ 10- 15	+ 483	+ 9
$ 15- 20	+ 340	+ 4
$ 20- 30	+ 286	+ 2
$ 30- 50	+ 38	---
$ 50-100	- 732	- 2
$100-200	- 7,346	- 6
$200 and over	-58,250	-15
AVERAGES	$ + 99	+ 3%

Source: Citizens for Tax Justice based on data fom the Joint Committee on Taxation and CBO. Bracket creep based on CBO inflation estimates of 1980: 12.6%, 1981: 9.4%, 1982: 6.4%, 1983: 7.2%. Tax cut provisions include only rate reductions and lesser earning spouse deduction.

Taken literally the table above portrays not only a large shift of tax relief to upper incomes, but the average taxpayer being slightly worse off in 1984 in terms of actual tax change. The CBO inflation assumptions used in this report for 1983 (7.2%) may well be too high, and there appears to be an overstatement of the effect of bracket creep on the position of all income levels relative to tax cuts for the 3-year period. Nevertheless, the report is typical of charges being made on the unfair distribution of ERTA reductions.

It's obviously true that in absolute dollars the lion's share of the 1981-1983 cuts (assuming full implementation) will go to income groups of $30,000 and over. That's simply where the bulk of the tax liability is and in a basically proportional tax cut, that's where most of the relief will go.

Federal Individual Income Tax Burden Under Prior Law and
Under ERTA for Tax Year 1984 1/

Income 2/	Two-Earner Married Couple with Two Dependents 3/		
	Under Prior Law	Under the Act	Reduction
$ 5,000	$ -500	$ -500	$ 0
$ 10,000	374	261	113
$ 15,000	1,233	900	333
$ 20,000	2,013	1,469	544
$ 30,000	3,917	2,838	1,079
$ 40,000	6,312	4,615	1,697
$ 50,000	9,323	6,753	2,570
$ 60,000	12,634	9,211	3,423
$100,000	27,878	21,006	6,872

1/ Impact of the rate reductions and the deduction for two-earner married couples. Assumes that deductible expenses are 23% of income.

2/ Assumes that all income is wage and salary or self-employment income.

3/ Assumes lesser-earning spouse earns 25% of combined income.

Source: Joint Committee on Taxation

Percentage Distribution of Major Individual Income Tax Reductions Over Income Classes

Expanded Income ($000)	Average of Major Cuts 1/ 1969-1977	ERTA 1984 Impact	Prior Law Distribution Total Tax Liability 1981 Income Levels
0-3	8.6%	0.2%	0%
3-5	14.6		
5-10	32.6	2.4	2.2
10-15	24.5	5.4	5.7
15-20	12.2	7.8	8.0
20-30	9.0	20.7	20.4
30-50		31.3	29.9
50-100	0.8	18.5	18.0
100-200	-2.4	7.5	8.4
200+		6.1	7.4

1/ Includes reductions in 1969, 1971, 1975, and 1977. Weighted averages of constant dollar distribution by AGI (not expanded income).

Source: Joint Committee on Taxation; Office of Tax Analysis, Department of the Treasury; Tax Foundation calculations.

The above tables show the effects of the ERTA rate cuts and lesser earning spouse deduction on the distribution of tax liabilities under ERTA compared with major tax cuts of the 1969-1977 period. The major provisions of the 1981 Act certainly are proportional to the prior law distribution of tax liabilities and far less skewed than the average of earlier tax cuts which attempted to redistribute income downward. In the latter connection, it is important, of course, to assess what happened under ERTA, not only in relation to the present picture, but also what went before--the policy decisions of earlier years.

When the likely bracket creep effect during the next two years is considered, the statutory tax cuts do shrink for all income groups. The effect on the lower incomes could be significant, in part, because many of those with incomes below $10,000 are paying little or no income tax now. Inflation will kick some of them into the first bracket and that will be a tax increase, but it doesn't have much to do with ERTA itself. Under the Administration budget inflation assumptions, which again may be too high given the recent progress against inflation, all income classes do come out ahead through 1984 on the income tax alone. Afterwards, the indexing feature is scheduled to take effect in 1985, and if this happens, bracket creep will be neutralized and the value of personal exemptions kept in step with future inflation.

Now when we include Social Security taxes in these calculations the situation changes, but not in the way implied by Citizens for Tax Justice. With the likely increase in payroll taxes already set through 1982 and continued inflation, some people may well not achieve net tax cuts in the 1982-1984 period. But future increases in the Social Security burden will be felt the most, not among the lower income groups, but in the $30,000-$40,000 levels where the wage base subject to tax is expanding--estimated at $37,800 by 1984. The marginal rate meanwhile is scheduled to remain stable at 6.70% (until 1985 when it bumps to 7.05%). Therefore, those below the $30,000 level will get no Social Security tax boost, at least until 1985. Meanwhile, the one-earner couple with two dependents at $40,000 will see its Social Security tax burden rise $558 to $2,533 by 1984--a rise equivalent to 39% of its expected income tax cut (without regard to inflation). The onl way the first table can reflect a significant jump in Social Security burden at the low end is to include the 1981 rate increase of 52 basis points over 1980--not really a fair comparison with the ERTA results which don't have any real effect until mid-1982.

Payroll taxes are still regressive (although becoming less so as the wage base keeps being pushed up). They still hurt low and middle income groups more than upper incomes. But what is so often left out in the discussions of tax burden comparisons is the very progressive nature of the Social Security and disability benefits. As shown in Tax Foundation and other studies, when the Social Security tax and benefit sides are combined, the overall result is decisively progressive--not to mention the rapid growth in total benefits and the sharp rise in the replacement rate for retirees since 1972. Many of those who bewail the burden of Social Security taxes disregard what's happening on the benefit side.

There are provisions of ERTA which undeniably do benefit upper income groups proportionately more but which cannot be distributed accurately according to income class. These include the all-savers certificate program, IRA and KEOGH liberalizations, and the utilities' dividend reinvestment deferral. It is our judgment that these savings incentives, as well as the liberalization of foreign earned income treatment and the expanded capital gains exclusion on residences, will weaken the progressiveness of the tax structure somewhat but not enough to change the assessment of the overall bill as basically a proportional tax reduction.

Lastly in this area, there is the matter of bringing down the top rate of tax from 70% to 50%, a 29% reduction made effective as of last January whereas the rest of the rate structure will not achieve a slightly lower percentage reduction until 1983--maybe. This too must candidly be considered a break for upper incomes which, given the high savings potential of the affected taxpayers, should not "cost" the government anything in terms of the deficit problem. Fairness of such a move also must be considered in the context of the history of marginal rates going as high as 91% as recently as the mid-1960s. And to what extent is it equitable to tax anyone's marginal dollar of return at rates in excess of 50%? This certainly will be a matter for discussion if the rumored surcharge on upper incomes becomes a more serious proposal.

Safe Harbor Leasing

In our summary of ERTA last September (Special Report of 9-1-81) we observed that the leasing provisions could prove "controversial." That perhaps was the understatement of the year. Actually, most of the fuss has centered not on the question of public subsidy to marginal firms as we had anticipated, but on the matter of a relatively few profitable firms substantially reducing their effective tax rates by participation in the leasing program as "buyers" of depreciation deductions and investment credits. This is so despite the fact that both Treasury and Joint Committee on Taxation studies show that a high proportion of total tax benefits under safe harbor leasing in 1981 went to the "sellers"--the marginal firms. Even a higher proportion is expected to go to the sellers in subsequent arrangements as the market has been developed and become more efficient.

It should be remembered that the purpose of leasing provisions, in addition to encouraging full utilization of ACRS, was to discourage merger and takeover activity that might have been engendered if ACRS benefits were not available to marginal firms. Further, the leasing provisions were thought to be a more accepted and efficient means of assisting marginal firms than the refundable investment credit.

The business community has begun to utilize the leasing provisions in significant volume indicating they are working to encourage investment that otherwise might not have been made. The leasing provisions are thus an integral part of overall capital recovery reform. Congress, of course, could act to limit the extent to which profitable firms can reduce their tax liabilities under the leasing program. This might defuse some of the bad publicity, but it would also lessen interest in the market and possibly make it less efficient. If Congress simply repeals these provisions, a substitute means of transferring depreciation deductions and investment credits will have to be developed. There probably would be a lot of discouraging uncertainty in the meantime.

Unrequited Simplification

Wouldn't it be nice if we could do away with all the "loopholes," multiple deductions, exemptions, credits, and complicated forms, and have a nice, flat rate income tax--a low rate, of course, with a reasonably general flat exemption at the bottom? This is the typical April 15th editorial, and this year it bloomed in profusion. The typical editorial then goes on to bemoan the unlikelihood of ever achieving this nirvana of tax policy because of the array of "special interests" that would fight like tigers to retain their tax breaks.

Well, we do have a complicated Code and it doesn't seem to be getting any easier to deal with overall. One big exception to that, however, is the Accelerated Cost Recovery System. Even the harshest critics of this program will have to admit that it should be far simpler than former depreciation practice, particularly for small business and individuals.

As for a gross income or much broader-based net income tax, this certainly is not difficult to construct from strictly a policy view. It can be demonstrated readily that getting rid of many special provisions could result in a significant lowering of rates and bring in the same order of revenue. Blueprints for Basic Tax Reform, the Treasury study of 1977, did this in quite elegant fashion for a model comprehensive income tax and an alternative model cash flow (or consumption) tax. There are some legislative proposals right now directing the Treasury to make new studies of such options.

Why, then, is major tax simplification considered a politically naive idea? For one thing, the "special interests" working to preserve tax breaks are far more inclusive than the fat cats said to benefit the most from all those special deductions. The special interests include not only the wild-catter defending intangible drilling costs and the high income investor in lithographic plates, but the college professor tenaciously defending deductions for a home office where papers may be corrected, as well as the stewardess who sees no reason why free flights to Majorca should be taxable income. Eve special provision attracts its own crowd, and you find them through all income classes.

It's still true that itemized deductions are of most value to upper incomes. But in recent years we have seen a considerable spread of tax credits for everything from energy conservation to child care to political contributions. Credits against tax liability tend to increase the stake in such provisions proportionately across the taxpayer population. When such credits are refundable, of course, as with the earned-income credit, they become important to low income groups, including those with no tax liability. Even more significant for low and moderate income groups are some major flat exemptions from tax including the zero bracket amount or standard deduction which was increased nine times since 1969, the exclusion of Social Security and disability benefits, the exclusion of most unemployment and all workers compensation, the exclusion of public assistance, etc.

The latter are important to lower income groups in keeping them off the income tax rolls entirely or subjecting them only to the lowest marginal rates. This can be gauged by reference to the "tax expenditure" budget--the list of all so-called "abnormal" benefit provisions in the Code. The tax expenditure budget is a wobbly concept and chock full of problems of definition and measurement. But, for the sake of argument, take the list and its distribution by income class as given by the Joint Committee on Taxation. It shows that upper income groups ($50,000 and above) do employ a high proportion of the dollar volume of tax expenditures (over 31%) while the groups below $15,000 account for about 21% of the tax expenditure list. But when you relate the use of tax expenditures to actual tax liabilities, the situation reverses with low income groups getting the highest benefit relative to taxes paid. The relative benefit actually is lowest in the middle income brackets of $20,000-$30,000 and highest at both extremes of income--not too surprising since the purpose of a great number of tax expenditures is to provide more income securi to the low end and counteract the effect of high marginal tax rates at the top.

Obviously, tax expenditures or special provisions are important to a wide spectrum of taxpayers and even non-taxpayers. As these special interests are really "us," little wonder that politicians pay so much attention to them.

The other major reason for our ferocious attachment to tax breaks is that we don't trust the rate structure, and we have serious doubts about political commitments to keep it from rising on most all of us. Despite some significant tax reductions and erosion of the tax base in the 1960s and 1970s--which held the overall level of federal income tax receipts personal income relatively stable--the system itself became steadily more progressive. This was documented in a very good OTA paper by Eugene Steuerle of the Treasury last April. A chart from that paper is reproduced (on page 8). As shown, back in 1961, 90% of individual returns faced a marginal tax rate of no more than 20-22% (the first brackets then) with only 10% of returns above those rates. By 1979, almost two decades later, about half of all returns were taxed at higher marginal rates than in 1961. About 30% were taxed at lower rates than in 1961 mainly because the bottom rate was dropped to 14% in 1964. Elsewhere, the move up the bracket ladder was swift, particularly at the high end. At the 95th percentile, marginal rates increased sharply from 26% in 1961 to 38% by 1979.

Actually, this comparison understates the extent of the increase in progression. Even if a taxpayer stays in the same rate bracket for an extended period, any increase in income will be taxed at a higher rate than the total income before. This has a most marked effect for all taxpayers at the top rate of 50% now and for those who had significant earned income but relatively little investment income, and therefore subject to the maximum tax of 50% after 1969.

Another way to look at the increase in progression and its effect on tax burdens is to compare shares of total tax paid by the higher income groups. Just for the 1975-1980 period, as shown below in Tax Foundation calculations, the share paid by the highest 10% of individual returns went from 48.6% to 51.8% and the share paid by the highest 25% of returns increased 66.4% to 77.5%. It should be noted that a great many in the highest 25% can hardly be described as fat cats, with AGI reaching down to $28,400, and an average tax burden of $8,228.

Federal Income Taxes Paid by High and Low Income Taxpayers
All Individual Returns - 1975 and 1980

Adjusted Gross Income Class	# Returns 1980 (mils.)	Income Level 1975	Income Level 1980	Percent of Tax Paid 1975	Percent of Tax Paid 1980	Average Tax 1975	Average Tax 1980
Highest 10%	9.4	$23,425 or more	$34,103 or more	48.6	51.8	$7,367	$13,748
Highest 25%	23.4	15,895 or more	21,423 or more	66.4	77.5	4,359	8,228
Highest 50%	46.8	8,930 or more	12,815 or more	92.9	94.0	2,815	4,985

Source: Tax Foundation computations based on Treasury Department data.

In sum, the rate structure has changed from a basically flat levy for the great majority of taxpayers to one of significant progression. Some of this was due to real growth of incomes but a lot was simply the interaction of graduated rates and inflation--the fabled bracket creep. The significance of the increase of progression for savings and investment has been debated hotly. But there is no question that it happened and that it has had a very significant impact on people's perception of the income tax. Since the politicians didn't protect us from bracket creep, we devoted our energies to preserving and enhancing all kinds of other ways to protect parts of our income.

Sure, a flat rate of income tax would solve this problem. But is the U.S. Congress really ready to abandon the ability to pay principle--integral to a structure of graduated rates--on permanent basis? Remember that the rate cuts under ERTA did not change the curve of graduation except slightly at the very top. Is Congress even willing to ensure that future inflation stops moving us up the rate treadmill without accompanying increases in the ability to pay? Given the track record, most of those loopholes may look a lot safer than a grandiose income tax reform.

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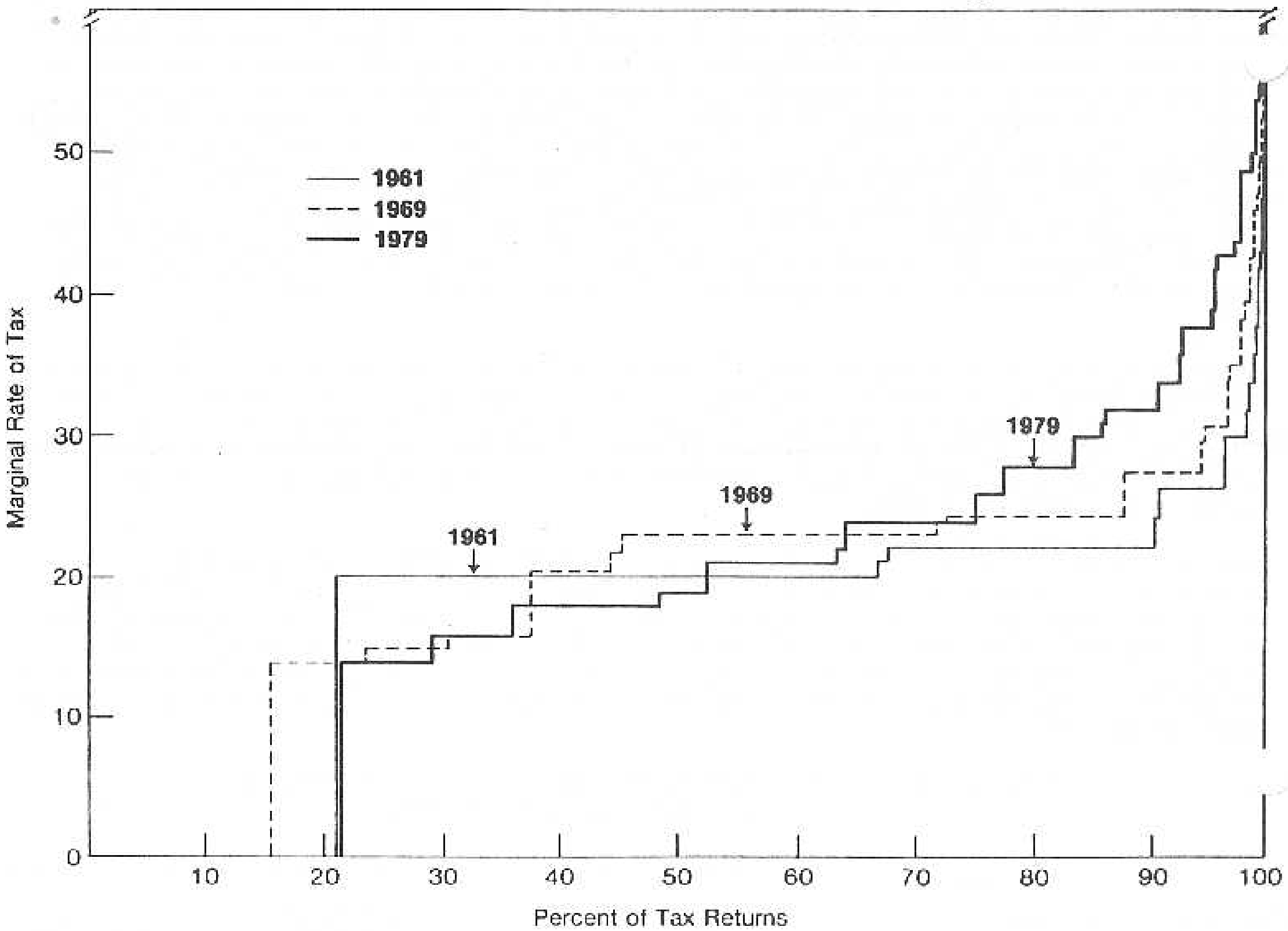
Cumulative Percent of Returns Taxed at or Below Each Marginal Rate of Tax



Source: OTA Paper 48, April 1981, U.S. Treasury Department.

TAX FOUNDATION INCORPORATED
1875 CONNECTICUT AVE. N.W., WASHINGTON, D.C. 20009
(202) 328-4500