

Federal Tax Policy 101

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Why Work on Federal Tax Issues?

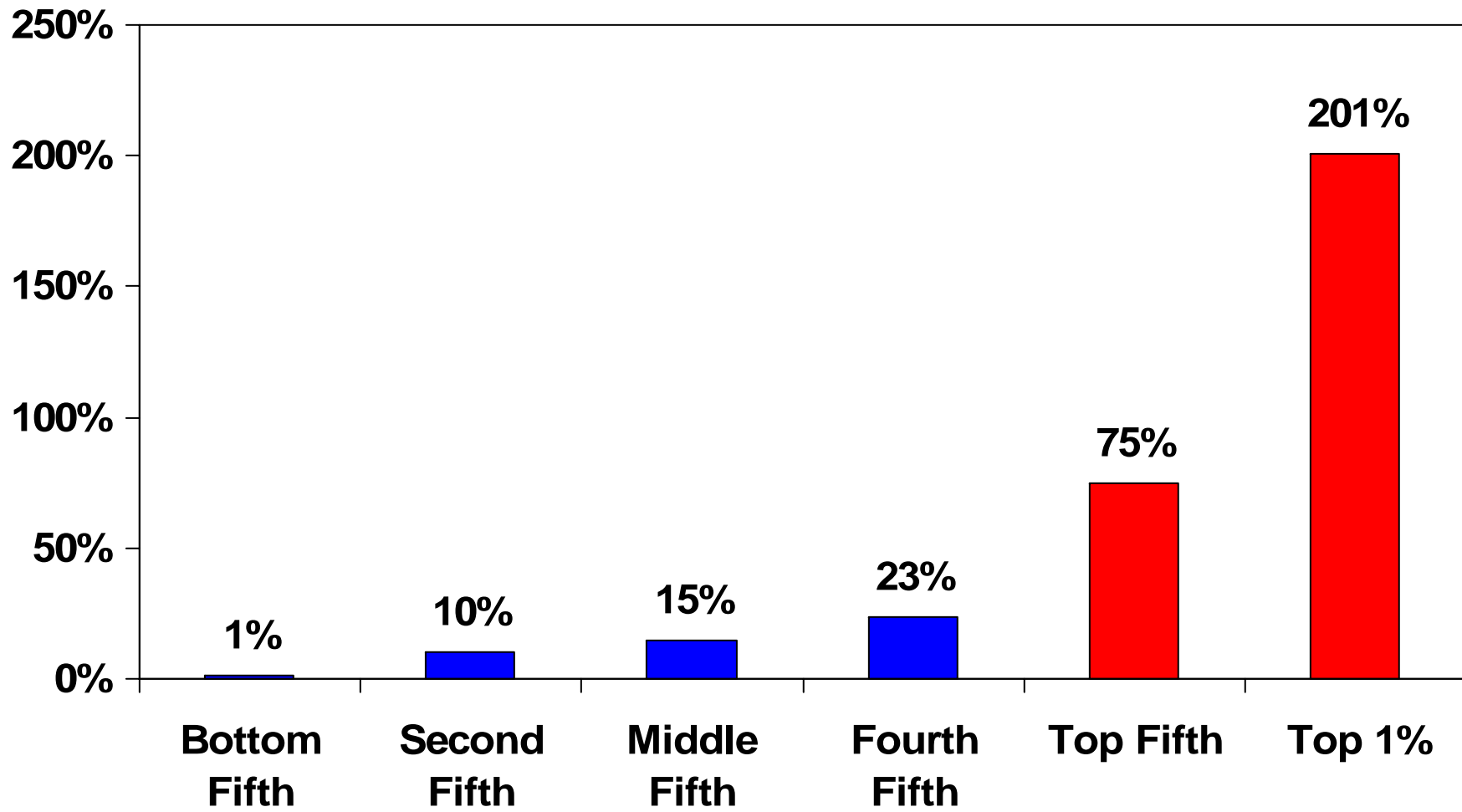
Federal tax policies:

- **Determine whether there are adequate revenues to fund important programs**
 - **Influence state as well as federal services**
- **Can narrow or widen gaps between rich and poor**
- **Directly affect low- and moderate-income households (EITC & Child Tax Credit)**

Part 1:
Federal Tax Policies &
Rising Income Inequality

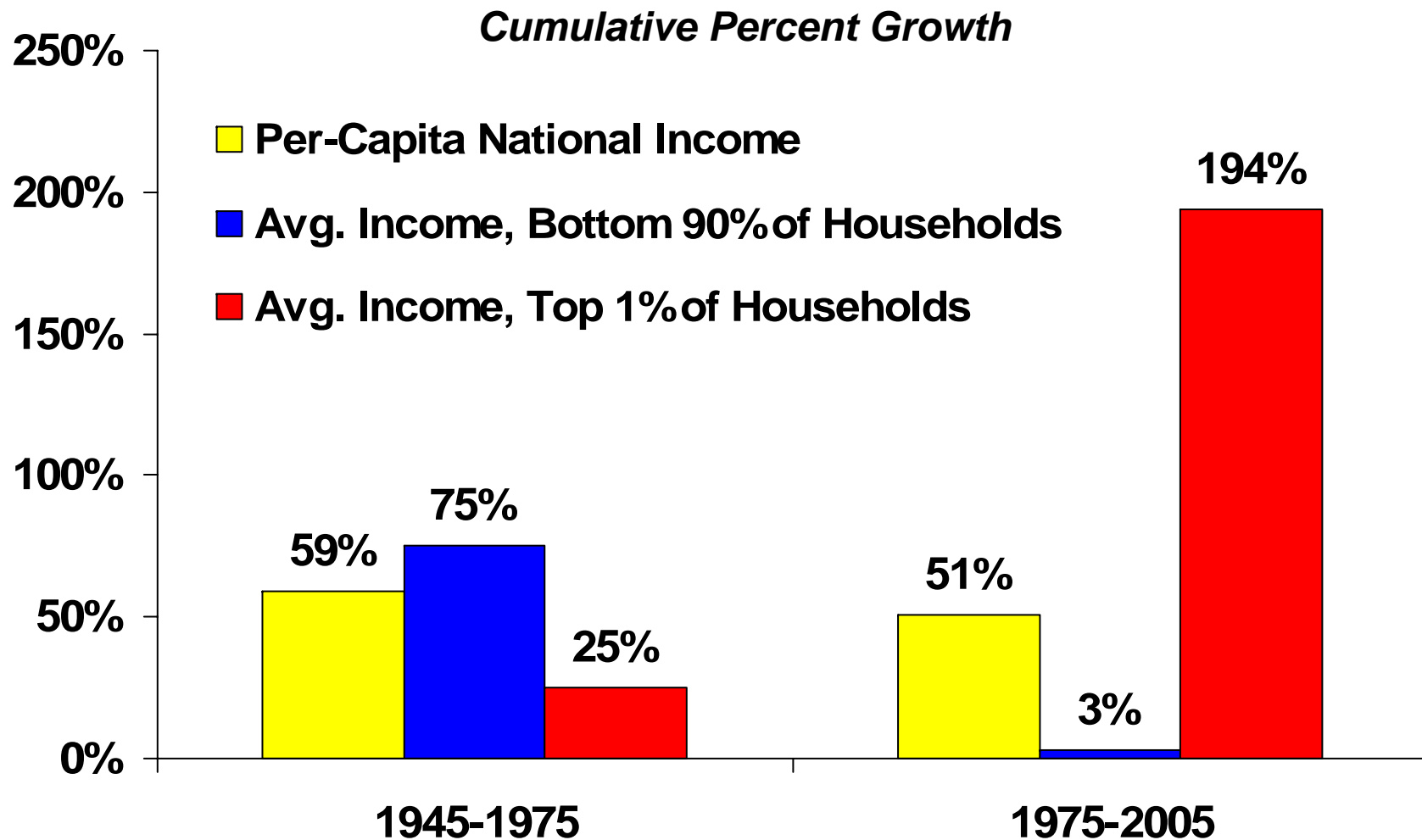
Last 25 Years Have Seen Rapid Income Growth at the Top, Virtually No Growth at the Bottom

Growth in Average Pre-Tax Income, 1979-2005, Adjusted for Inflation



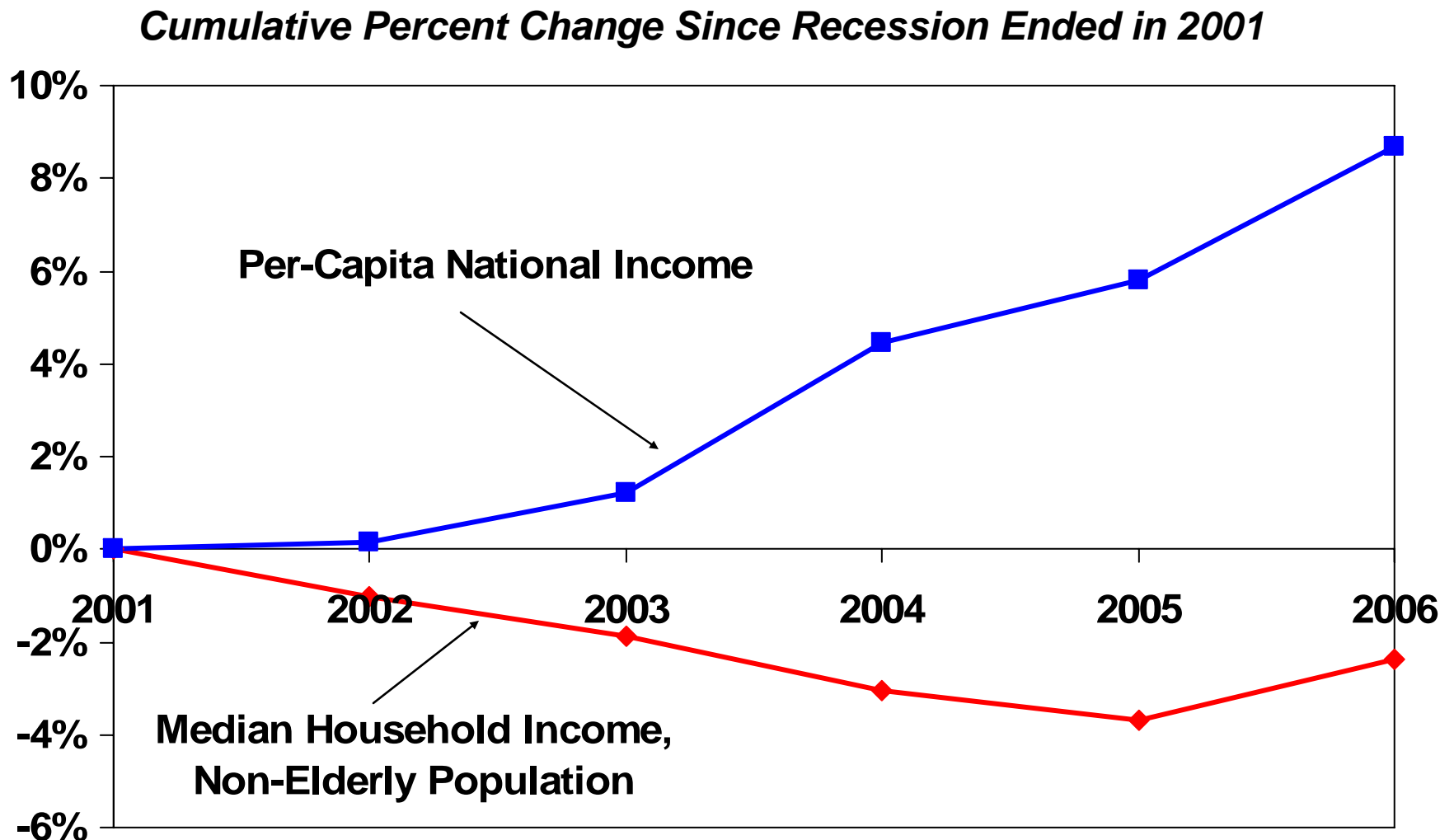
Source: Congressional Budget Office

Different From Earlier Era, When Growth Was Widely Shared



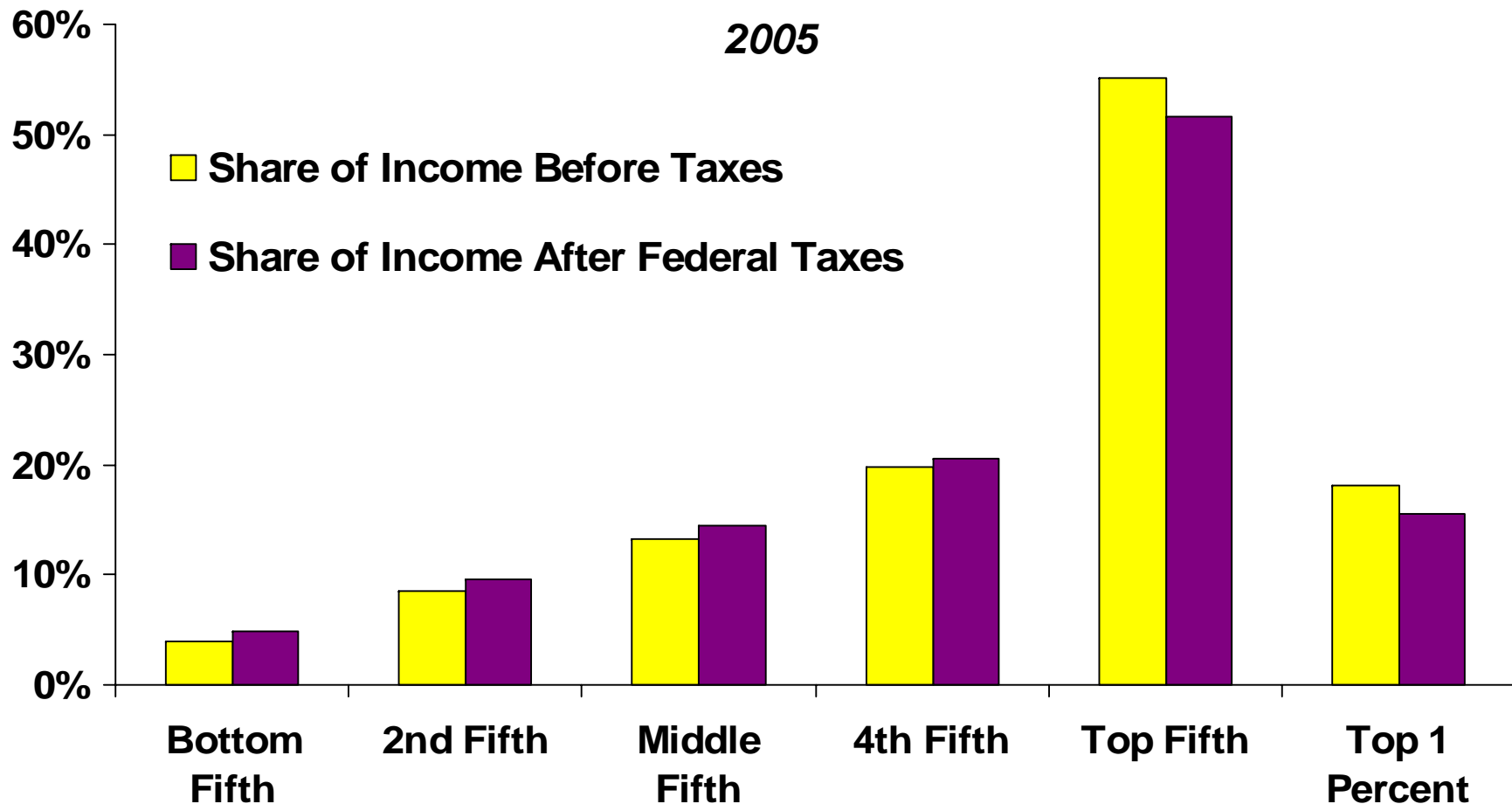
Source: CBPP calculations based on data from economists Thomas Piketty & Emmanuel Saez & BEA and Census data.

Typical Working-Age Household Has Seen Income Losses During the Current Expansion



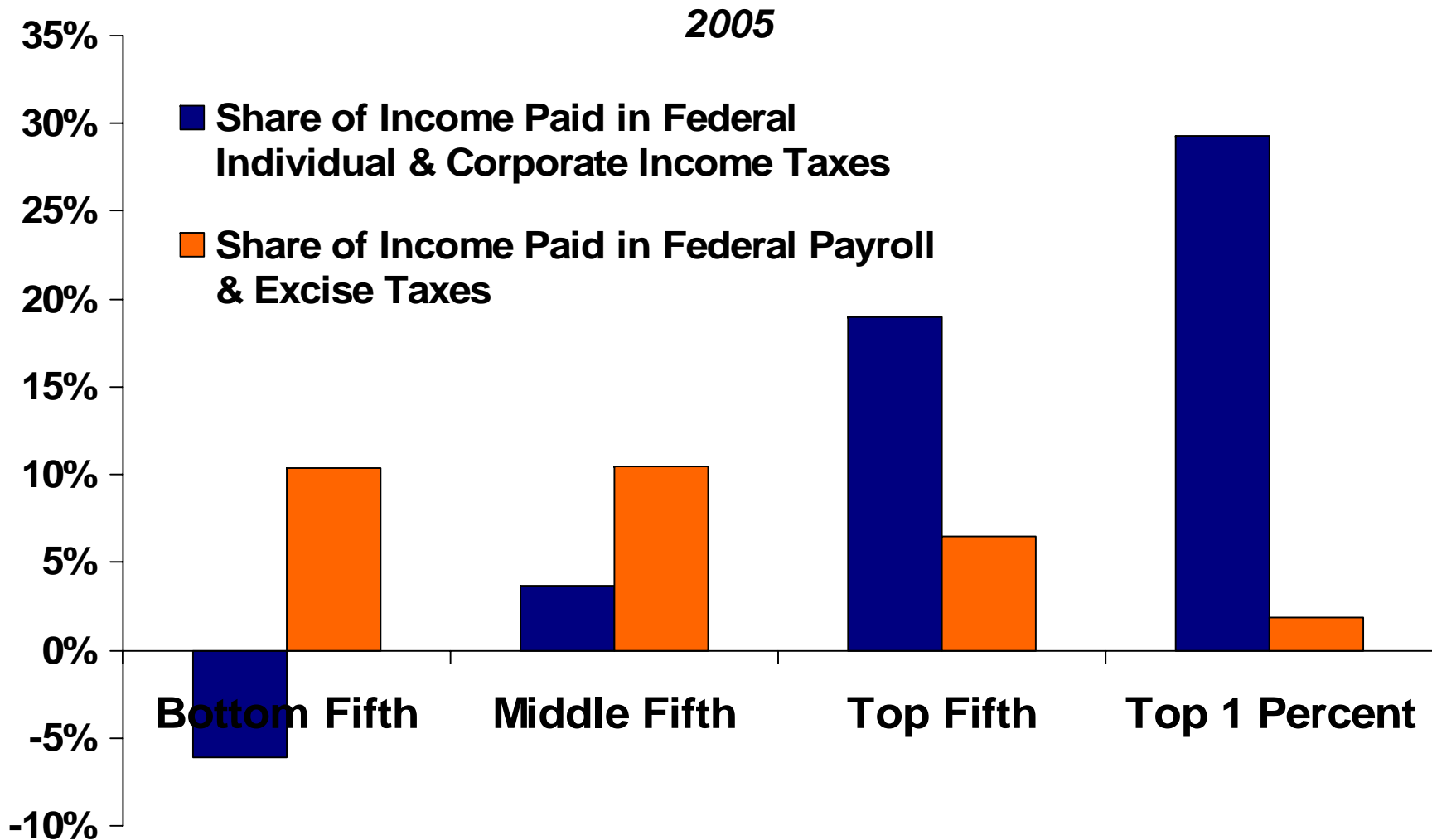
Source: Census Bureau and Commerce Department data. Figures are adjusted for inflation.

Federal Tax System Modestly Reduces Income Inequality



Note - For a family of four, income cut-offs are: bottom fifth, up to \$36,000; second fifth, \$36,000-\$61,000; middle fifth, \$61,000-\$90,000; next fifth, \$90,000-\$135,000; top fifth, above \$135,000; top 1 percent, above \$615,000. Source: Congressional Budget Office

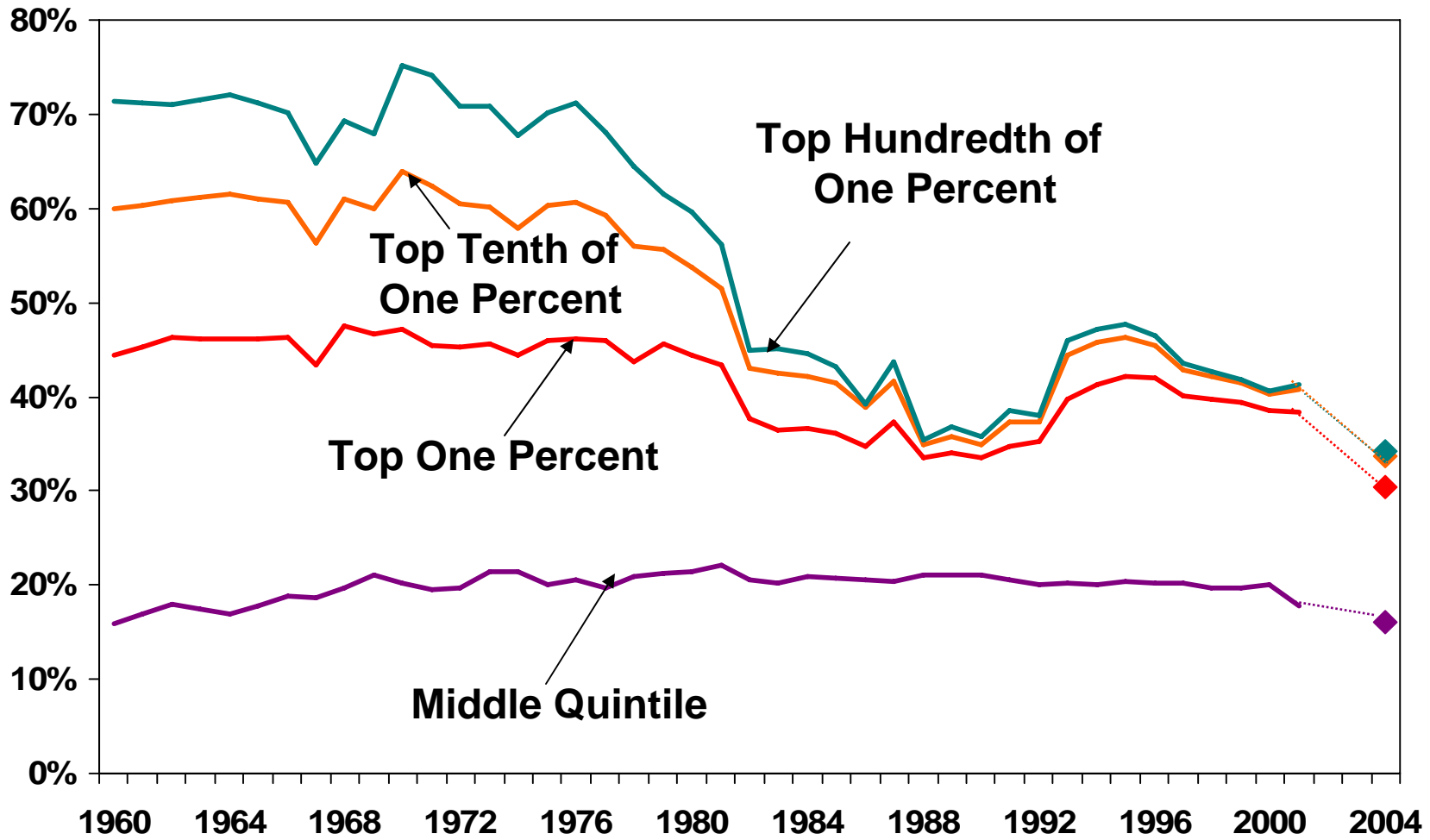
Progressivity Results From Individual & Corporate Income Taxes



Source: Congressional Budget Office

Federal Tax System Has Become Significantly Less Progressive

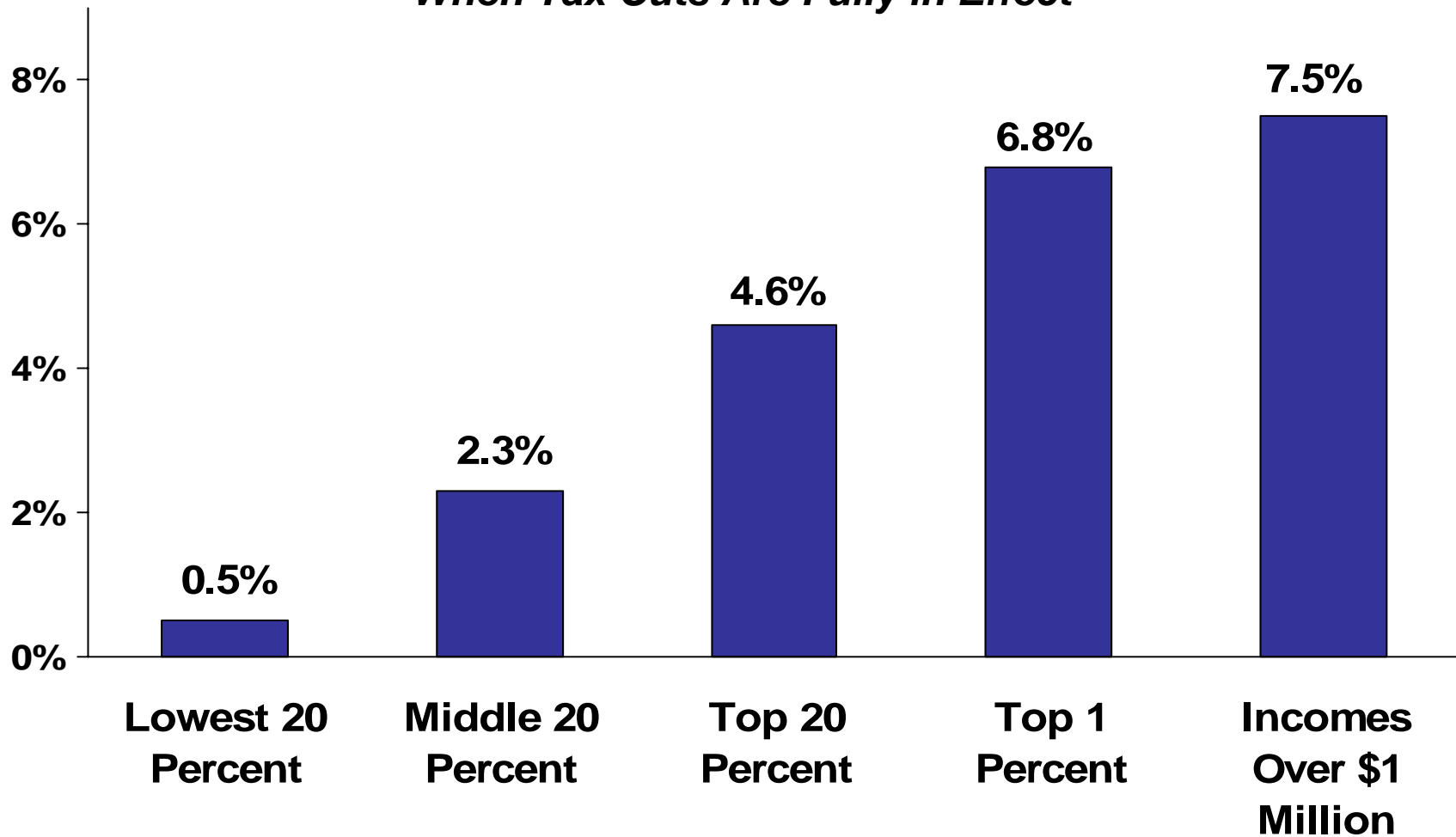
Effective Federal Tax Rates, 1960-2001, and Projected Tax Rates for 2004



Source: Thomas Piketty and Emmanuel Saez, based on IRS data

2001 & 2003 Tax Cuts Exacerbated Income Inequality

Percent Increase in After-Tax Income From 2001 & 2003 Tax Cuts When Tax Cuts Are Fully in Effect



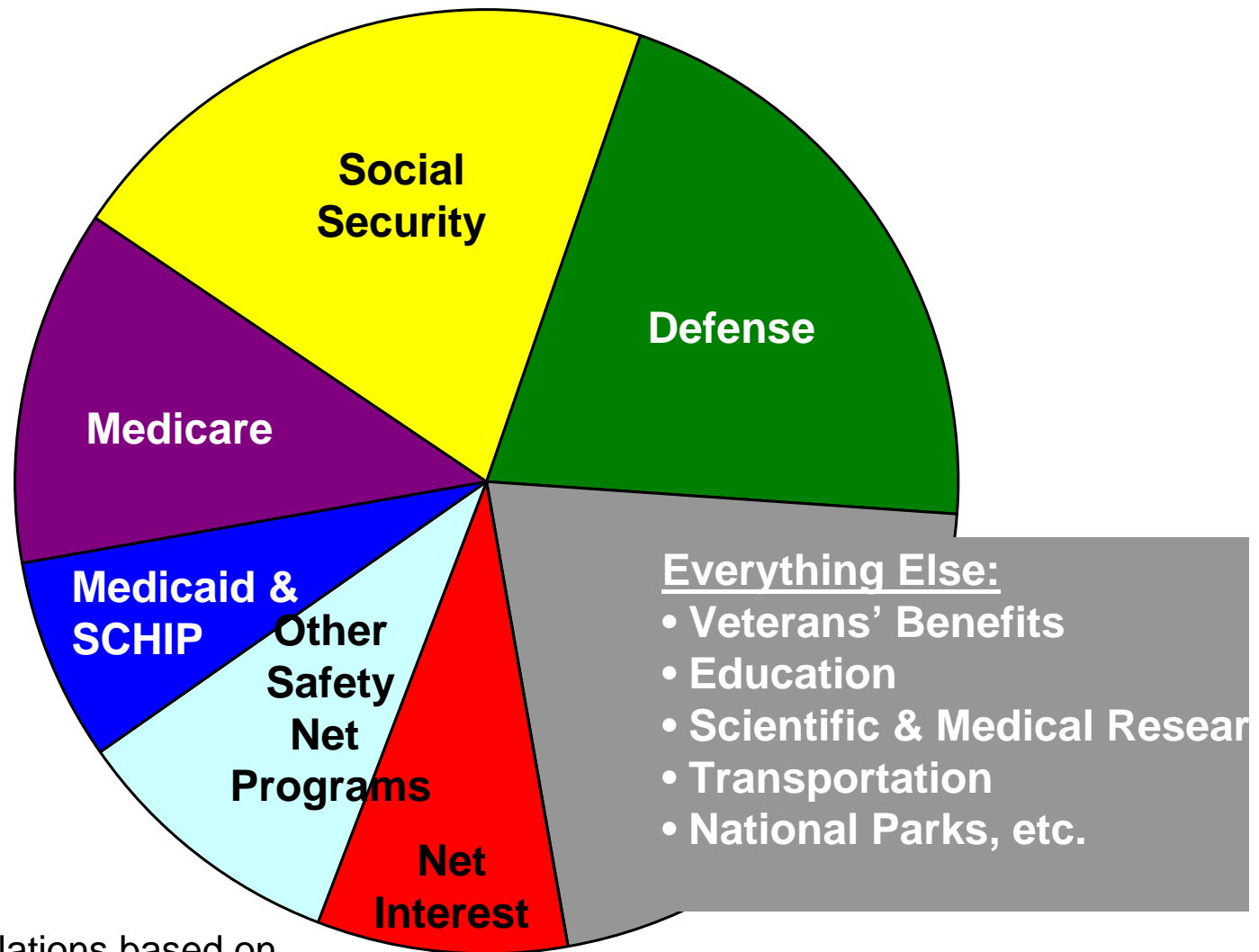
Source: Tax Policy Center

Tax Policy Could Have Mitigated Growing Inequality, But Instead Exacerbated It

- **Had tax rates stayed at 1979 levels, average income of top 0.1% would have risen \$1.2 million 1979-2004, adjusted for inflation.**
- **In fact rose by over \$2 million.**
 - **Additional \$600,000 due to reductions in effective tax rates, 1979-2000.**
 - **Additional \$250,000 due to 2001 & 2003 tax cuts.**
- **Resources that went toward lower effective tax rates (tens of billions per year) could have gone toward public purposes.**

Part 2:
The Connection Between
Taxes and Services

Where Do Our Tax Dollars Go? The Federal Budget in 2006



Source: CBPP calculations based on Office of Management and Budget data

Half Full:

Accomplishments of the Safety Net

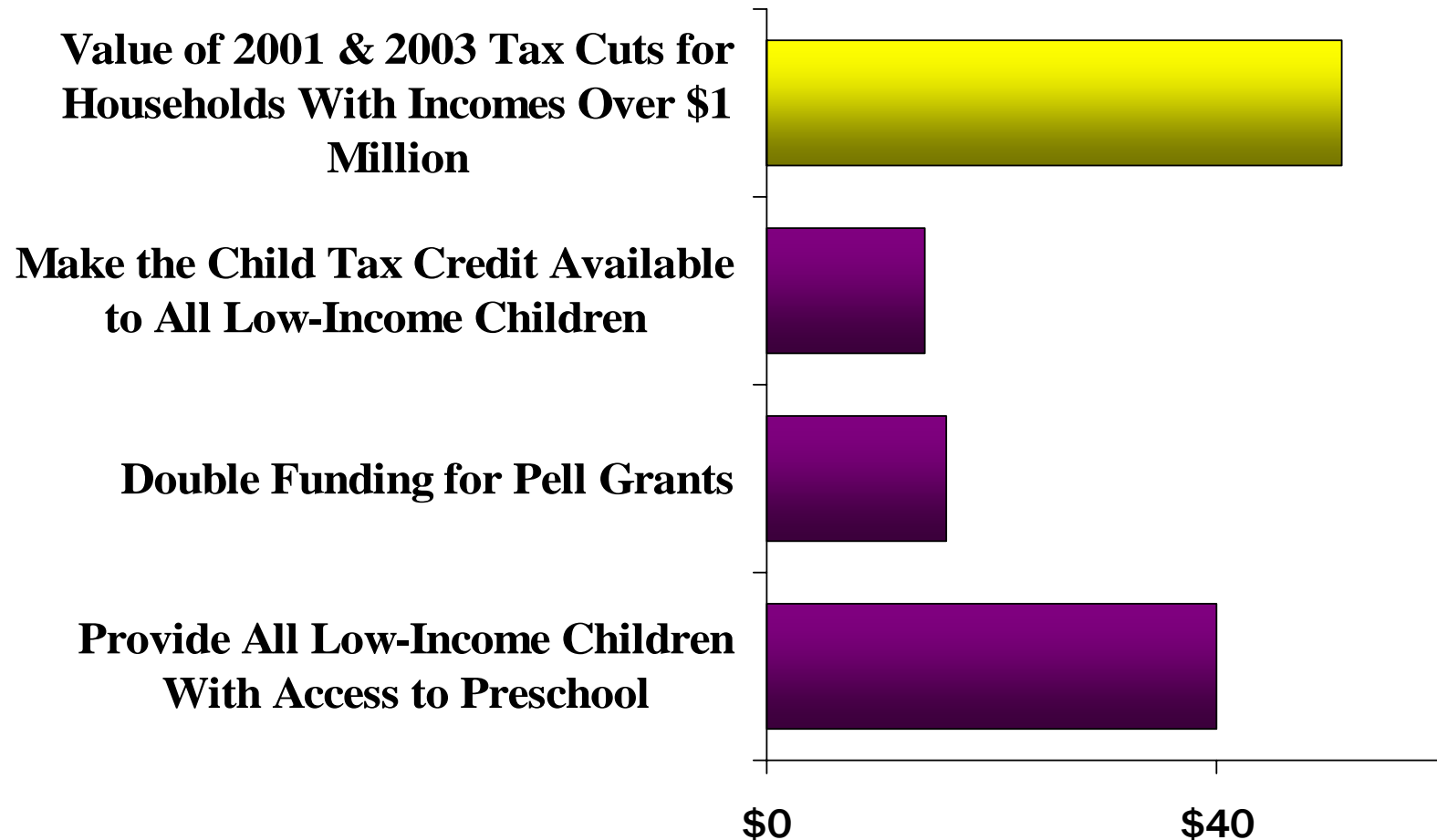
- **Lifts 27 million people out of poverty, including 14 million elderly people and nearly 5 million children**
- **Provides quality health care for 50 million low-income children, parents, elderly individuals and people with disabilities each year (not including Medicare)**
- **Has helped make hunger in the U.S. rare**
- **Improves the quality of housing for millions of individuals**
- **Provides critical support to working parents, e.g. Earned Income Tax Credit, housing & food assistance, Medicaid, child care & preschool**

Half Empty: Holes in the Safety Net & Missed Opportunities

- **47 million Americans lack health insurance**
- **Safety net is frayed:**
 - Even when all benefits are counted, 31 million people live in poverty. 3.2 million children live below *half* the poverty line.
- **Widespread consensus that investments in early childhood education and health would yield large payoffs**
 - Most low-income working families with children don't get help paying for child care and many children don't have access to quality early education programs
- **Education and training opportunities for low-skilled adults and those with disabilities are very limited**

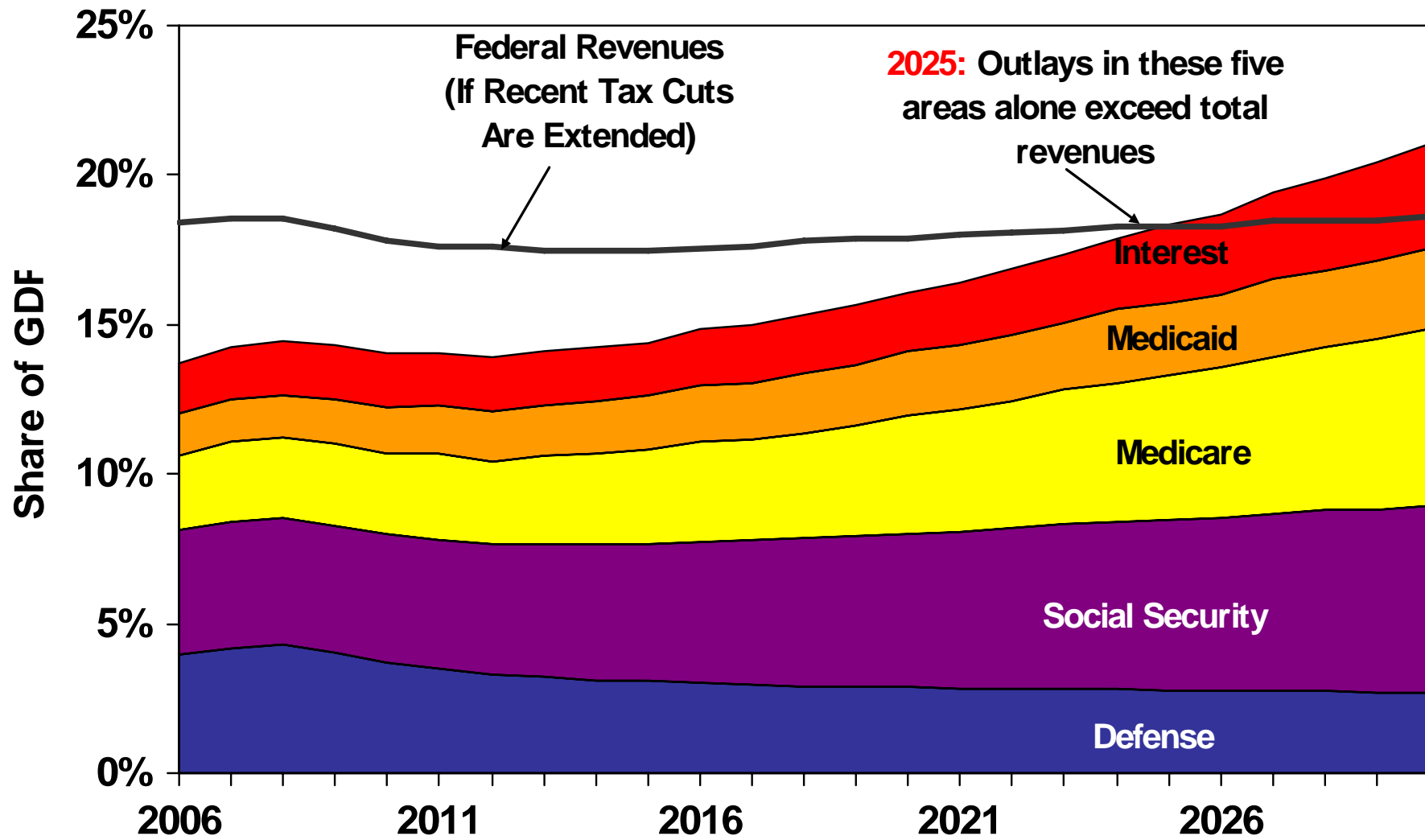
Resources Used for Tax Cuts Were Not Available for Investments

Approximate Annual Savings/Costs, Billions of Dollars



Source: CBPP calculations based on Tax Policy Center, Joint Tax Committee, and OMB data, and Sawhill & Ludwig 2007.

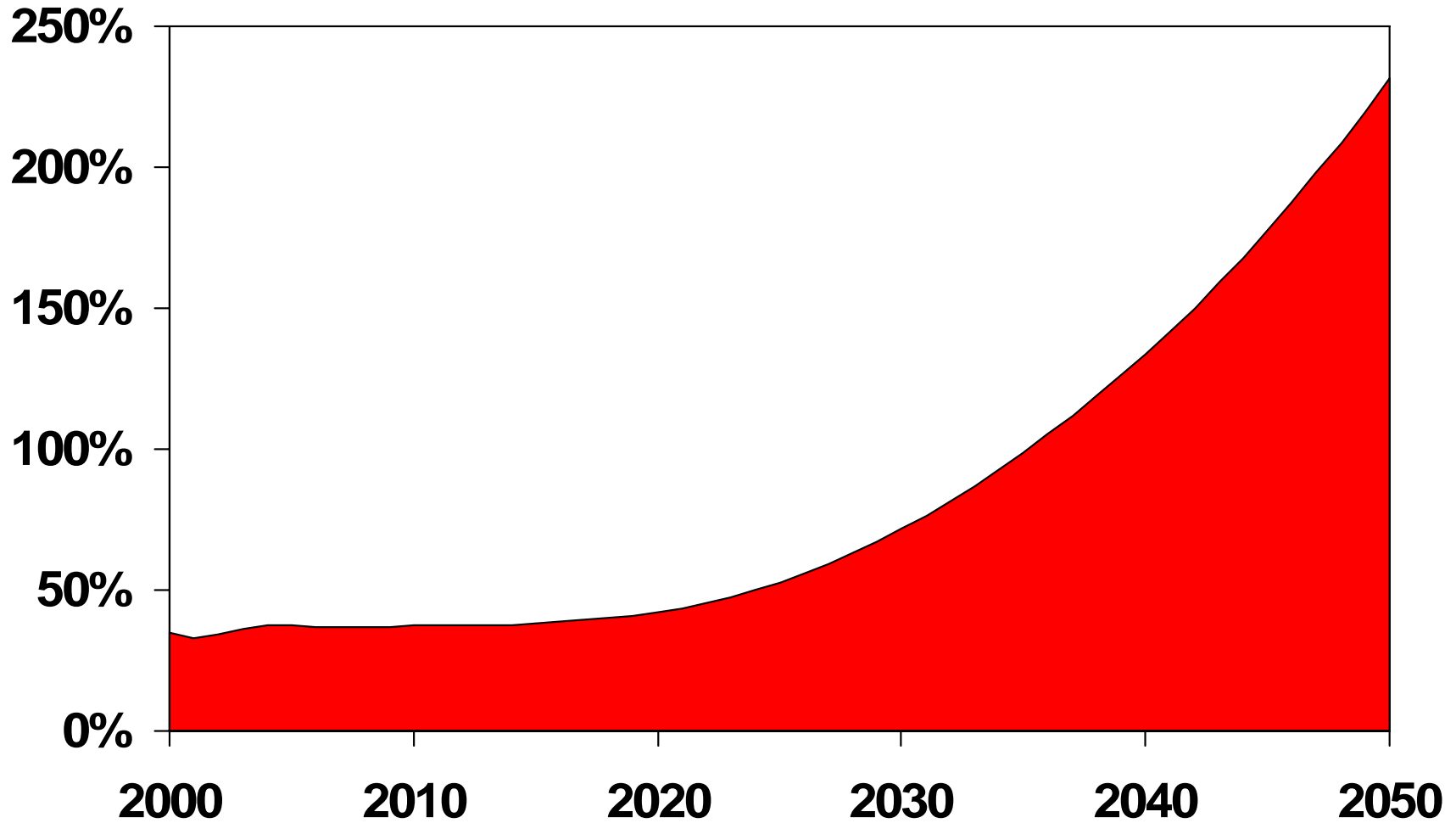
Looking Ahead: Tightening Budget Squeeze



Source: CBPP calculations based on Congressional Budget Office data

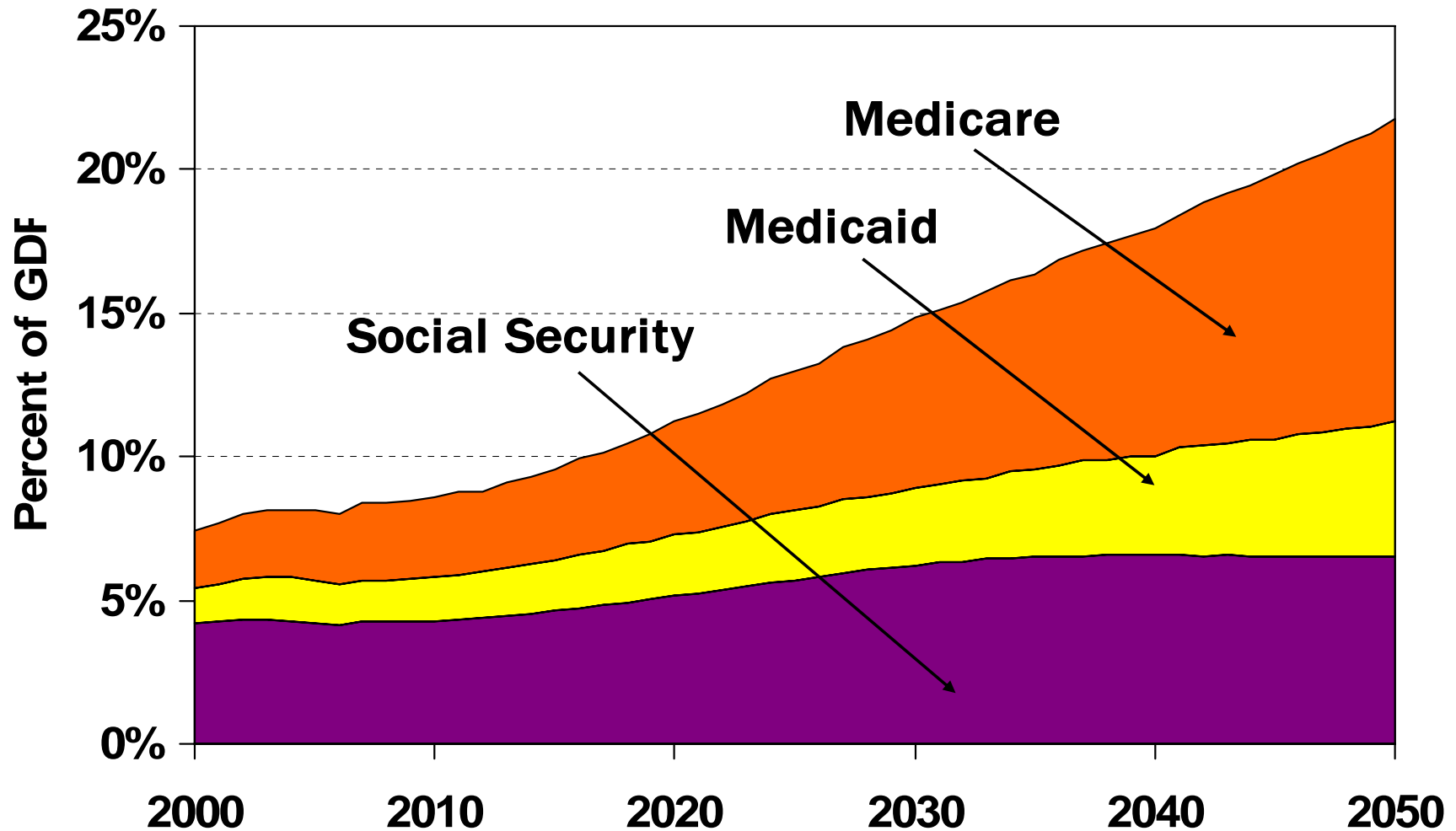
Current Policy Course Is Not Sustainable

Debt as a Share of GDP



Source: CBPP projections based on Congressional Budget Office data.

Medicare, Medicaid, and Social Security Costs Expected to Rise Rapidly



Source: CBPP projections based on Congressional Budget Office data.

Rising Health Care Costs Largest Factor Behind Rising Program Costs

- Health care costs are projected to rise rapidly in *both* the public and private sectors.
- Costs have risen at about the same rate in the public and private sectors in the past for the past several decades.
- Main drivers of health spending growth:
 - Rising incomes
 - Progress in medical technology
- ***But*** high costs also reflect large inefficiencies.
- Reform is essential, but probably not desirable to eliminate all health spending growth.
- Trying to slow public sector growth without slowing private sector growth would result in a two-tiered health system.

What Would We Have To Do To Restore Balance Under Current Revenue Policies?

Hold the per-person growth rate of Medicare and Medicaid costs to the growth rate of per-person GDP

AND

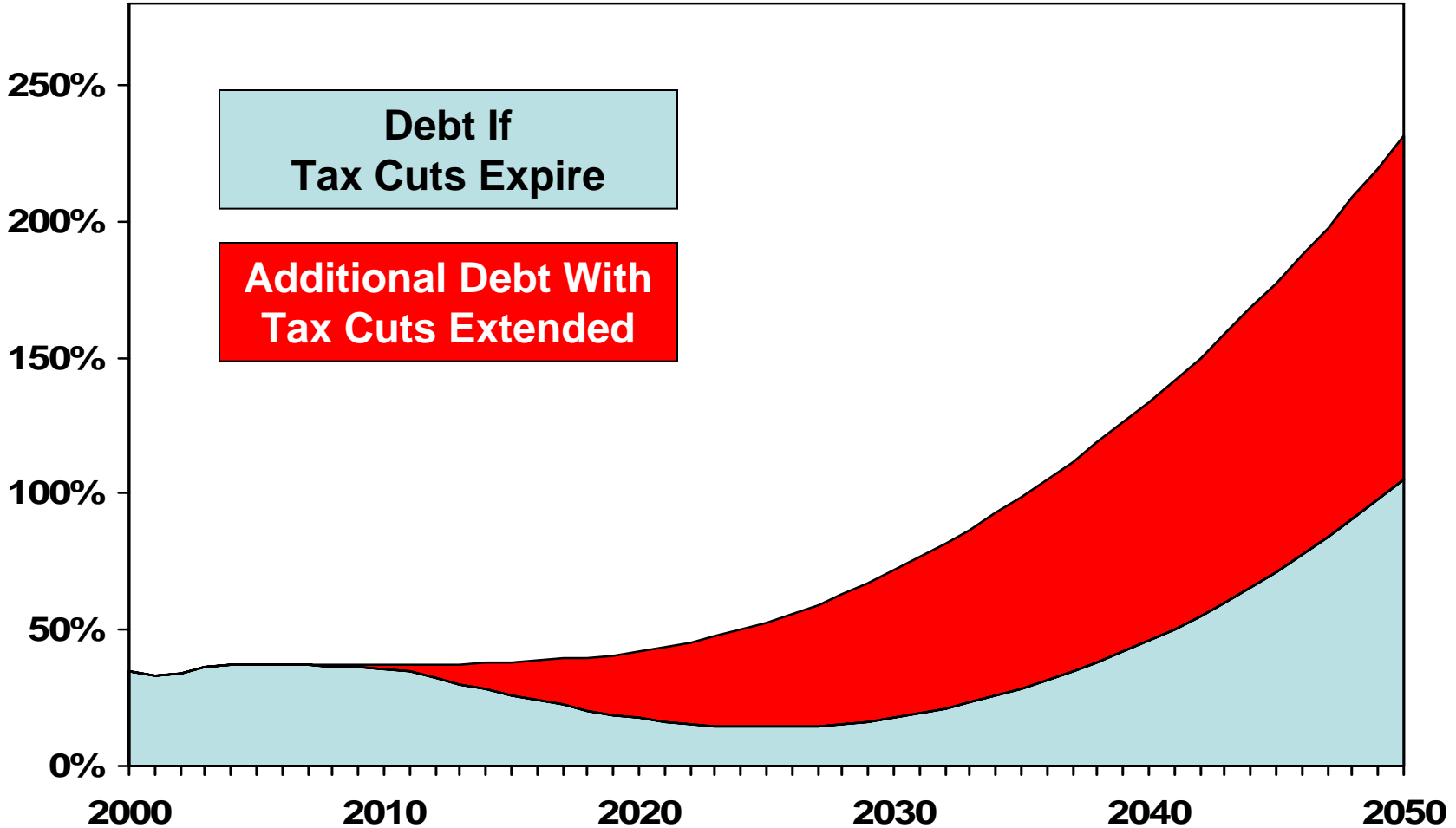
Restore Social Security solvency through benefit cuts alone

WHILE

Making no new investments

Not Extending or Paying for Tax Cuts Would Buy Several Decades of Time

Debt as a Share of the Economy



Source: CBPP calculations based on Congressional Budget Office data.

Part 3:
Confronting Myths About
Taxes and Tax Cuts

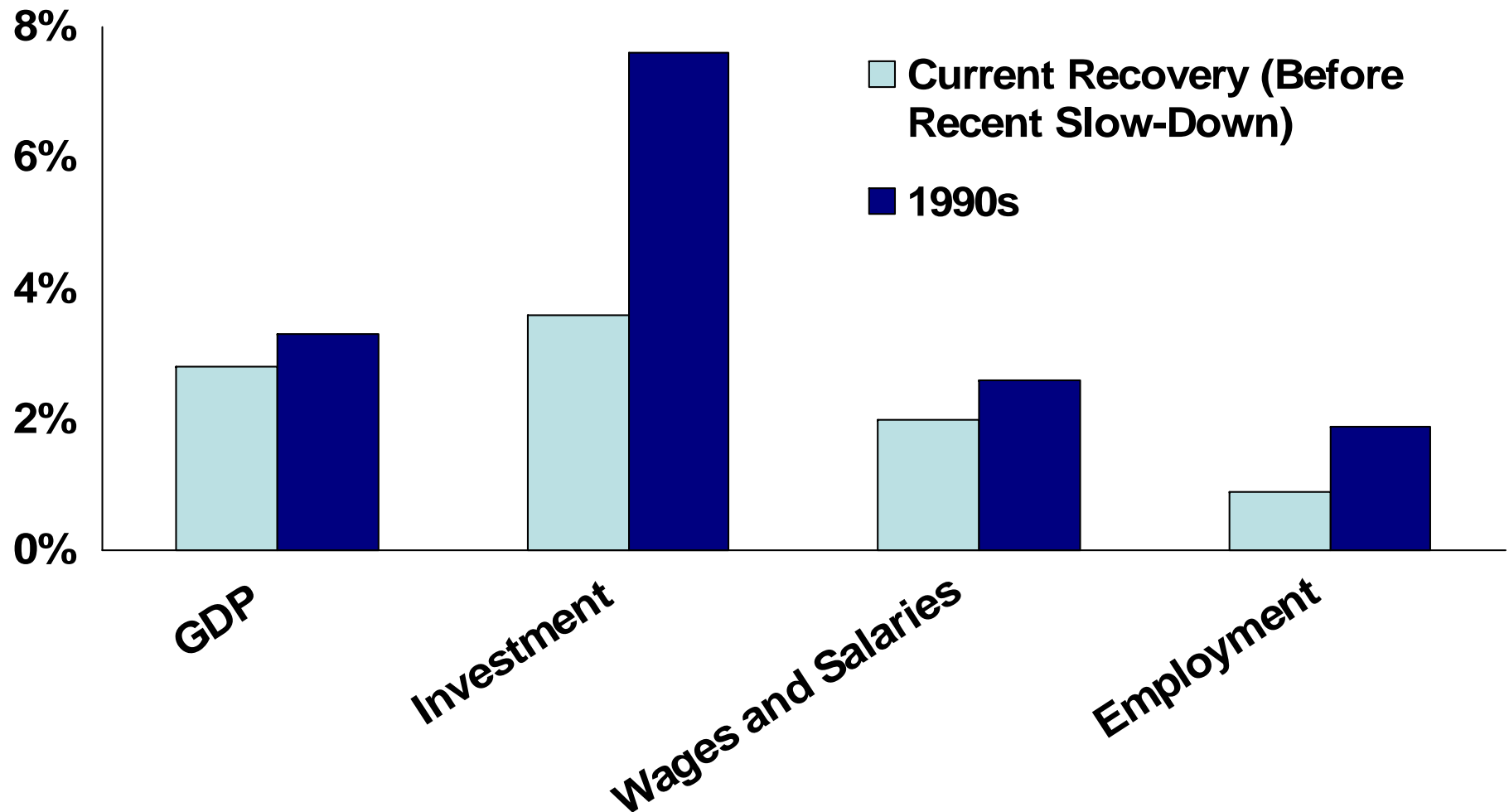
Two Key Myths About Taxes & Tax Cuts (Two Sides of the Same Coin)

Myth #1: Higher revenues would devastate the economy, and so we have no choice but to run deficits or cut programs.

Myth #2: We don't have to choose between tax cuts and services, because tax cuts will "pay for themselves."

Economy's Overall Performance Somewhat Better in 1990s

Average Annual Growth Rate, Adjusted for Inflation



Source: BEA, BLS data

Adding to Deficits Likely Worse for the Economy Than Letting Tax Cuts Expire

"Growth effects [of individual and corporate income tax rate cuts] eventually become negative without offsetting fiscal policy [i.e. if not paid for]... because accumulating Federal government debt crowds out private investment"

-- Joint Committee on Taxation

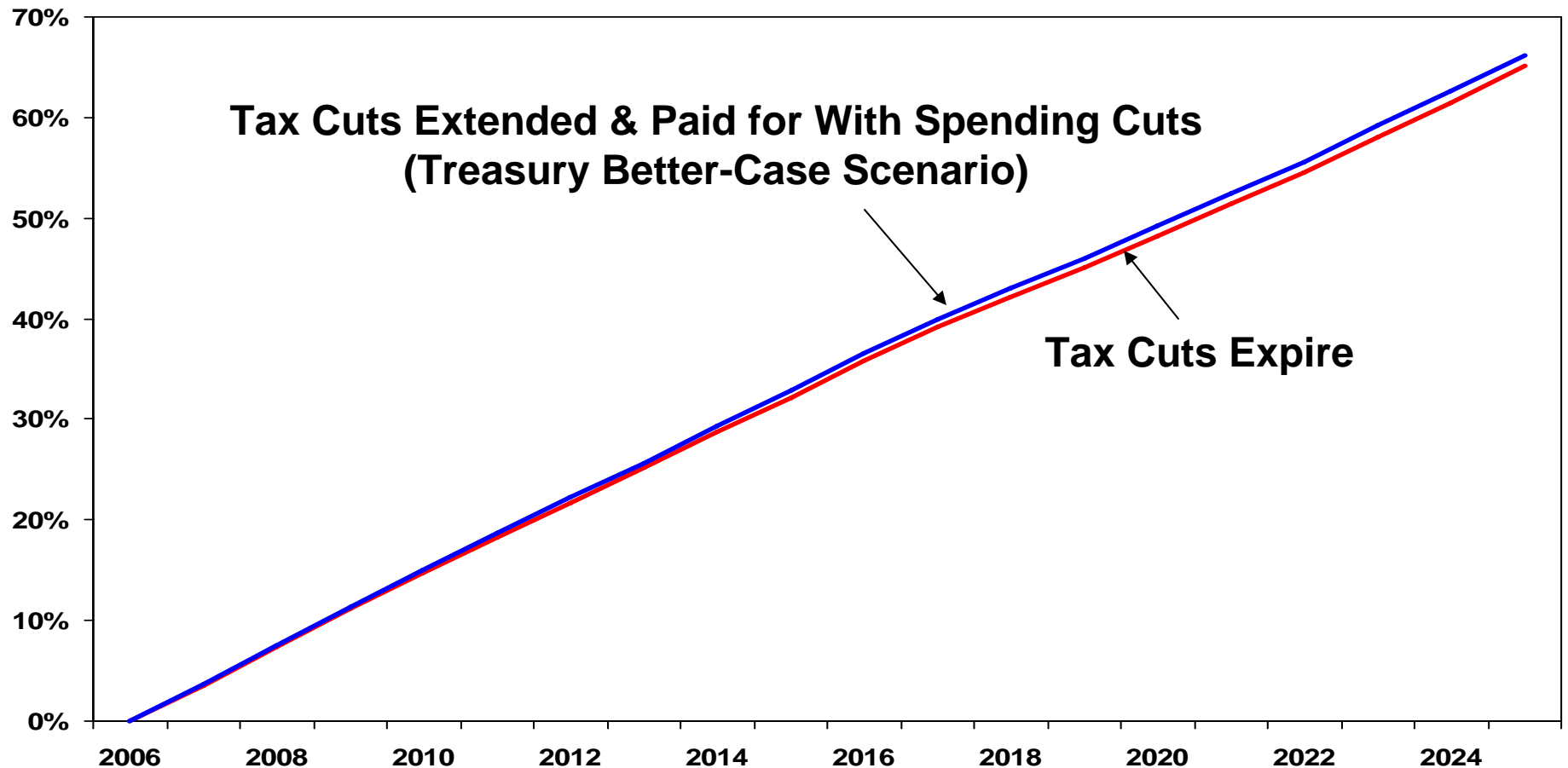
"Making the 2001 and 2003 tax cuts permanent would raise the cost of capital for new investments, reduce long-term investment, and reduce economic growth."

**-- William Gale, Brookings Institution; and
Peter Orszag (formerly of the Brookings Institution,
now director of Cong. Budget Office)**

Studies by **Federal Reserve economists, the Congressional Research Service, the Congressional Budget Office**, and other noted experts have produced similar findings regarding the effects of unpaid for tax cuts.

Treasury Simulations: Effects of Even Paid-For Tax Cuts Are Small

Percent Increase in Real GDP through 2025



Note: Treasury did not provide year-by-year numbers to the specific annual path is illustrative only.

Economists Across the Political Spectrum Agree: Tax Cuts Lose Revenue

Senior White House economists reject the claim that tax cuts pay for themselves:

“I certainly would not claim that tax cuts pay for themselves.”

– Edward P. Lazear, Chair White House Council of Economic Advisors

“[There is] no credible evidence... [that] tax revenues... rise in the face of lower tax rates.”

– N. Gregory Mankiw, Former CEA Chair

Analyses by CBO, the Joint Committee on Taxation, academic economists, and the Administration’s own Treasury Department find tax cuts nowhere near pay for themselves. They may cost more than expected if financed by deficits, which harm the economy over the long run.

Major Tax Policy Decisions Will Be Made in Next Few Years

- Which tax cuts will be extended and which allowed to expire?
- Will the costs of extensions be offset?
- What will happen to the estate tax and the Alternative Minimum Tax (AMT)?

These choices will have major implications for revenues, programs, and the distribution of income – but *not* for the economy.

Bottom Line: Need to Decide What Level of Services We Want & Fund Them

- Main effect of taxes is to raise revenue.
 - Economic effects are modest.
- Question is what level of revenue funds a government that meets the nation's needs.
- Persistent, large deficits – i.e. failure to fund the level of services we choose – *are* economically damaging.