
Our Tax System Revealed

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Topics

- ❖ Tax System Desiderata
- ❖ Follow the Money!
- ❖ Social Security Payroll Taxes
- ❖ Sales Taxes
- ❖ Federal Individual Income Taxes
- ❖ The Big Picture: Tax Expenditures
- ❖ NC Income Tax Cap Amendment
- ❖ Improving our Tax System

Tax System Desiderata

- ❖ Responsive to changing needs, politics, and events
- ❖ Enforceable and difficult to evade
- ❖ Simple and transparent
- ❖ Fair

Desiderata: Simple & Transparent

- ❖ Paul Ryan¹: “We’re making things so simple — we’re making things so simple that you can do your taxes on a form the size of a postcard.”
- ❖ Tax “reform” bill: 1097 pages
- ❖ Complexity makes it easy to lie to the public.
 - ❖ Q: How much income tax does a millionaire pay?
 - ❖ A: 37% (hardly!)

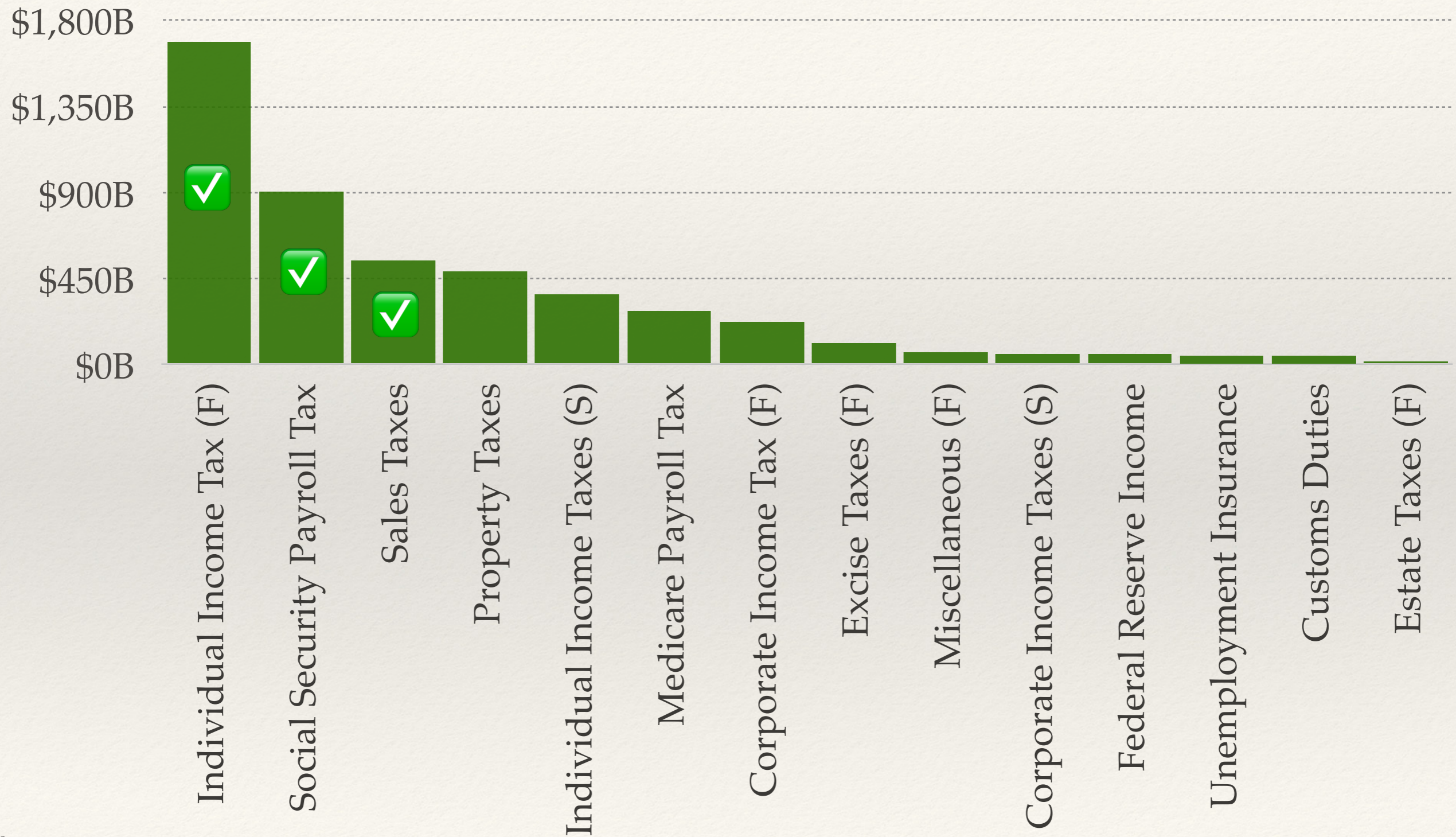
¹<https://www.nytimes.com/2017/12/16/us/politics/republican-tax-plan-simple-tax-returns.html>

Desiderata: Fair

- ❖ Fairness is in the eye of the beholder



Follow The Money!



Social Security Payroll Tax



Sales Taxes

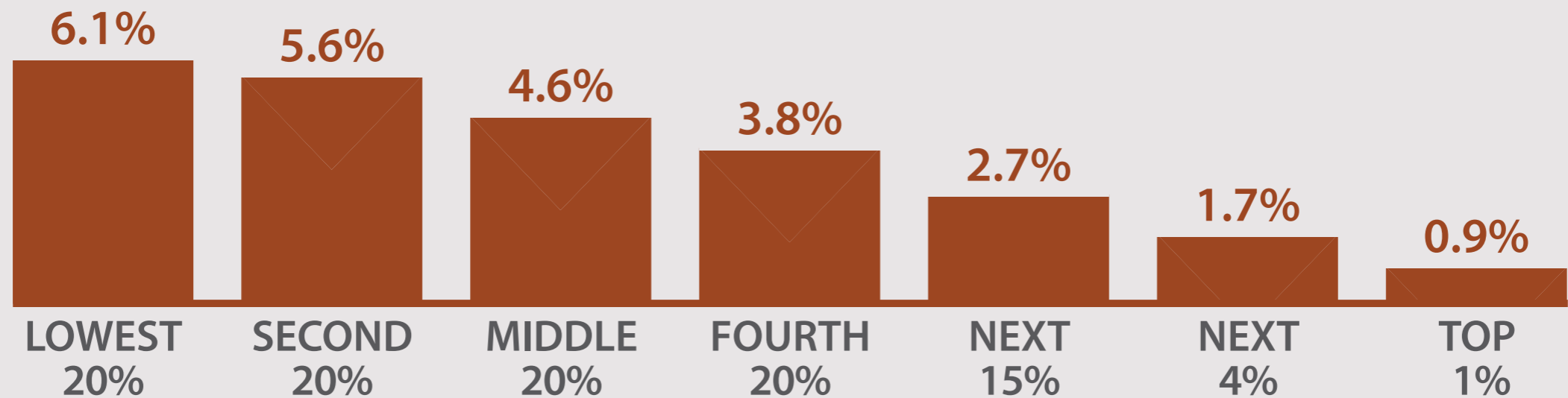
- ❖ Varies by state and locality (Orange County is 7.5%)
- ❖ Fixed percentage of cost of purchase, possibly with exemptions for “necessities” like food or clothing
- ❖ Sales tax is regressive
 - ❖ Lower-earners spend most of their earnings, so sales tax is applied to most of their income
 - ❖ High-earners spend less of their earnings, so sales tax is applied to only a small part of their income

North Carolina Sales Taxes



SALES & EXCISE TAX

Share of Family Income



Source: *Who Pays? A Distributional Analysis of the Tax Systems in all 50 States*, Institute on Taxation and Economic Policy, October 2018, p. 98.

Federal Individual Income Taxes

2018 Tax Brackets Married Filing Jointly

Tax Bracket	Tax Rate
Up to \$19,050	10%
\$19,051 to \$77,400	12%
\$77,401 to \$165,000	22%
\$165,001 to \$315,000	24%
\$315,001 to \$400,000	35%
Over \$400,000	37%

Q: Isn't 37% high?

A: No. In the 1950's the top marginal rate was over 90% on next dollar earned

Q: What percentage does a couple who earns \$250,000 pay?

A: 19.4%

Q: Really?

A: Nope! It's complicated.

Federal Individual Income Taxes

Deductions

Deduction Jargon

Gross Income	\$200,000	
Above-the-Line Deductions	-\$10,000	Examples: IRA contributions, health savings accounts, self-employed health care insurance, costs of moving for a job
Adjusted Gross Income	\$190,000	
Below-the-Line Deductions	-\$26,000	Examples: Home mortgage interest, charitable contributions, state and local income taxes, property taxes, large medical expenses
Taxable Income	\$164,000	Compute tax on this amount (not really — it's more complicated)

Deductions - Example

- ❖ \$5,000 deduction, which saves marginal rate \times \$5,000
 - ❖ For \$100,000 income, saves $22\% \times \$5,000 = \$1,100$

All Deductions Are Regressive Because a Given Deduction is Worth More to a Higher-Earner

- ❖ Lower earner spends \$5,000 to pay the interest
- ❖ Higher earner spends \$3,150 to pay the interest
- ❖ Subsidizing higher earner's housing more!

Deductions are Big \$\$\$

- ❖ In 2013, deductions for state and local taxes, mortgage interest, and charitable contributions yielded \$186B in subsidies. This was 1.1% of GDP!
- ❖ Of this, households in the top 20% of income got

Deduction	Benefit to top 20%
State and local income tax	80%
Mortgage interest	73%
Charitable Contribution	84%

- ❖ With benefits strongly skewed to the top 1%

Below-the-Line Deductions

- ❖ aka *Itemized Deductions*
- ❖ Requires filing Schedule A, which is only worthwhile if the deductions exceed the standard deduction
- ❖ In 2014, 30% itemized: 80% over \$100K; 7% earning less than \$30K
- ❖ Changes for 2018
 - ❖ Standard deduction increased (\$24,000 in 2018 for a married couple), so fewer taxpayers will use below-the-line deductions
 - ❖ Limitations on deductions of property and state/local income taxes
 - ❖ Pease phaseout of deductions for high-income people eliminated

Above-the-Line Deductions

- ❖ No Schedule A needed
- ❖ Always worth doing
- ❖ But, poorer people can't afford the activities, e.g.,
 - ❖ Contributions to traditional IRAs
 - ❖ Health savings accounts
 - ❖ Self-employed health care insurance
 - ❖ Self-employed retirement savings
 - ❖ Cost of moving for a job
- ❖ These deductions also benefit primarily wealthier taxpayers

Deductions Are Opaque

- ❖ Politician says 37% tax rate on \$1M income
- ❖ People think: “\$370K in taxes, that’s a lot. Seems fair.”
- ❖ But 37% is only the marginal rate, so the tax is much lower. Deductions and other breaks lower taxes even more.
- ❖ Most voters aren’t exposed to deductions, so it is easy for politicians to subsidize middle- and upper-class people without most people realizing it.
- ❖ Complicated rules and interactions, e.g.,
 - ❖ 17 pages to describe rules for mortgage interest deduction
 - ❖ 18 pages of instructions for Schedule A

Federal Individual Income Taxes

Credits

Credits

- ❖ Credit: subtract credit from tax owed, not from income
- ❖ 19 credits; examples:
 - ❖ Residential energy efficient property
 - ❖ Earned income tax credit (EITC)
 - ❖ Child tax; child and dependent care
 - ❖ Retirement savings contributions
 - ❖ American Opportunity

Credits Can be Progressive

- ❖ Same value, regardless of income, unless tax obligation is smaller than sum of all credits
- ❖ *Refundable credit*: if credit is larger than tax obligation, get a refund. Example: EITC
- ❖ *Non-refundable credit*: only reduces tax obligation. Example: dependent care credit
- ❖ *Carry forward*: e.g., residential energy efficient property
- ❖ *Partially refundable*: e.g., American Opportunity credit

Federal Individual Income Taxes

Exclusions

Income Excluded from Taxation

- ❖ Employer-sponsored health insurance
 - ❖ Exclusion reduces Federal revenues by \$248B
- ❖ Exclusion of net pension contributions and earnings
 - ❖ Delaying these taxes reduces Federal revenues by \$137B
- ❖ Up to \$500K in gains from sale of primary residence is not taxed
- ❖ Capital gain on assets transferred at death is not taxed
- ❖ Increase in value of incentive stock options is not taxed
- ❖ ...

Federal Individual Income Taxes

Preferential Rates

Preferential Tax Rates

- ❖ Long-term capital gains and qualified dividends have long received preferential rates tied to tax brackets
- ❖ 2018 introduces brackets just for capital gains and dividends, and further reduces taxes via inflation indexing of the brackets
- ❖ For 2018-2025 the rates (married filing jointly) are
 - ❖ Up to \$77,200: 0%
 - ❖ \$77,201 to \$479,000: 15%
 - ❖ Over \$479,001: 20%

Tax Expenditures: The Big Picture

Tax Expenditures

- ❖ Definition (Congress' Joint Committee on Taxation, 2017)
 - ❖ “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.”
 - ❖ “similar to direct spending programs that function as entitlements to those who meet the established statutory criteria.”
- ❖ Not in the Federal budget and rarely discussed!

The Big Picture

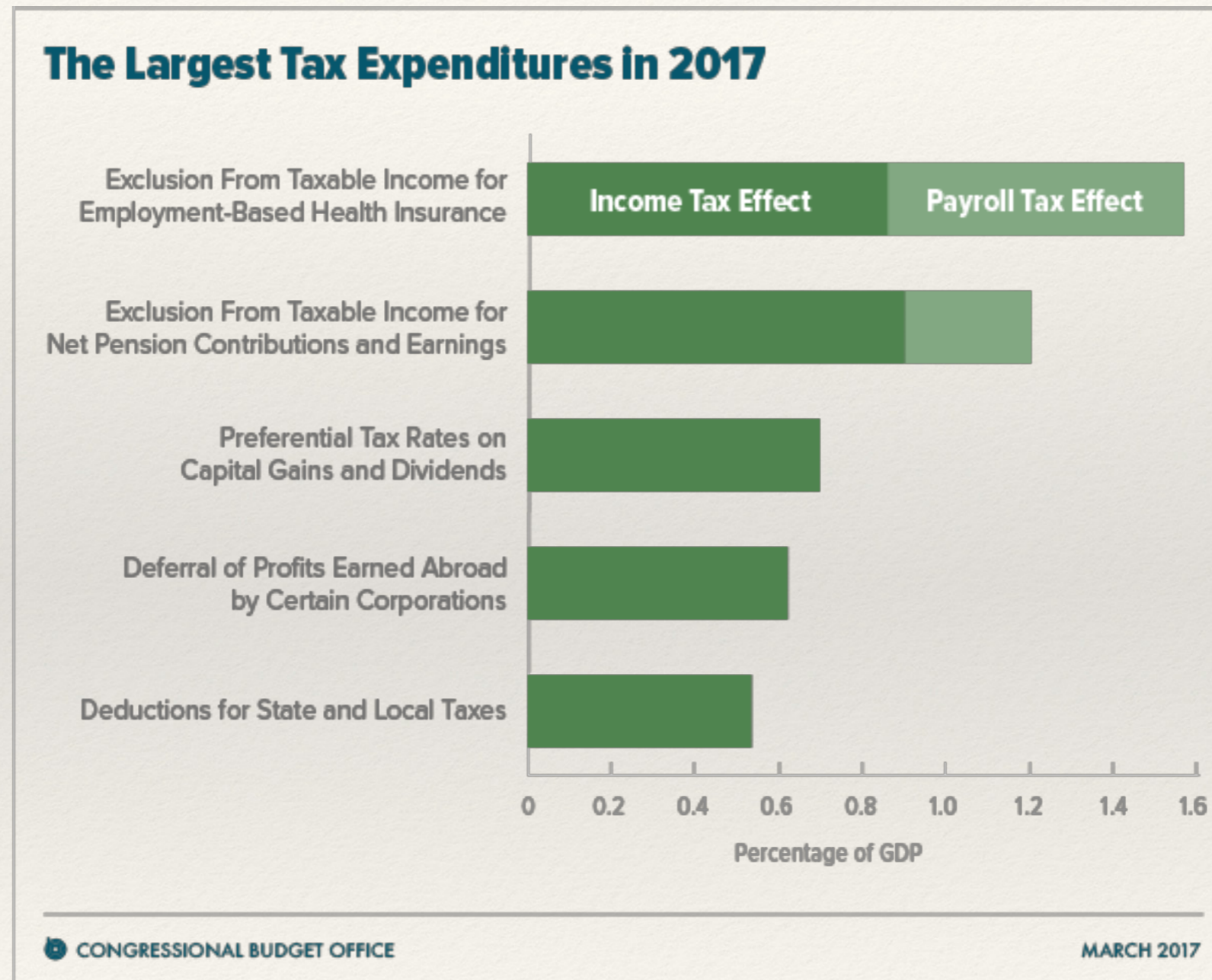
Revenues, Tax Expenditures, and Selected Components of Spending in 2017

Tax expenditures, projected to total more than \$1.5 trillion in 2017, cause revenues to be lower than they would be otherwise and, like spending programs, contribute to the deficit.

Percentage of GDP



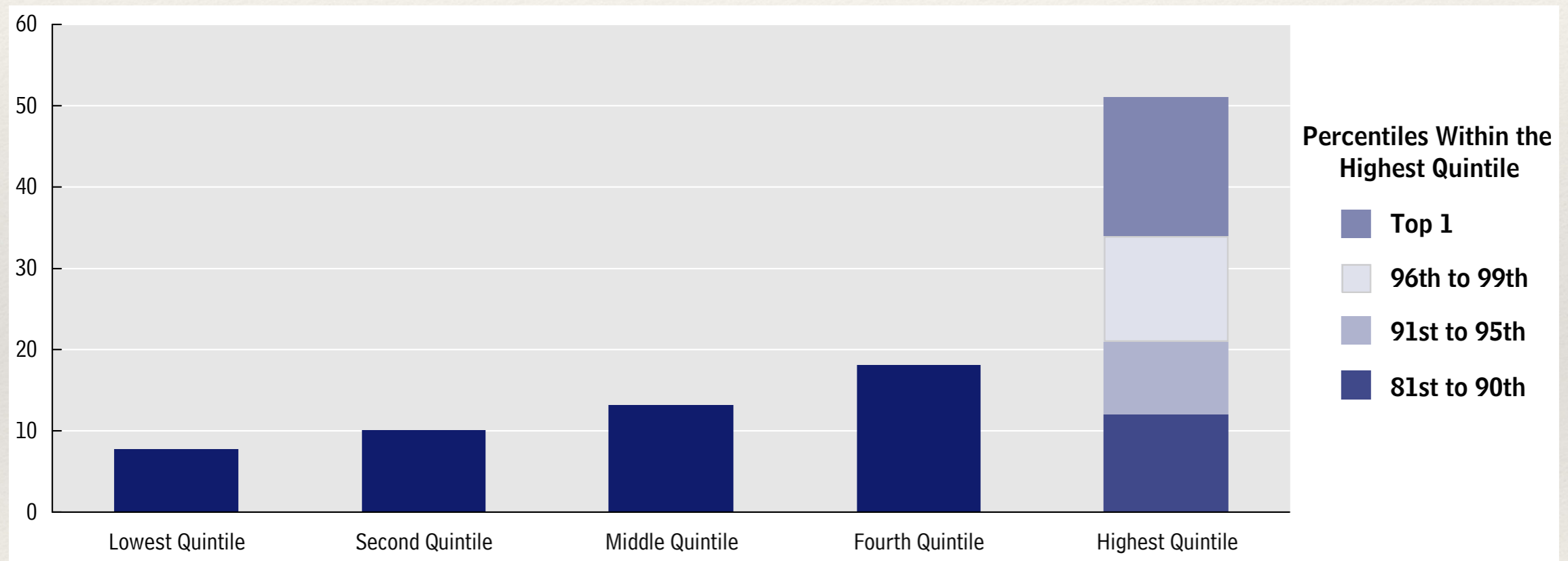
Largest Tax Expenditures



Who Benefits?

Shares of Selected Major Tax Expenditures, by Income Group, 2013

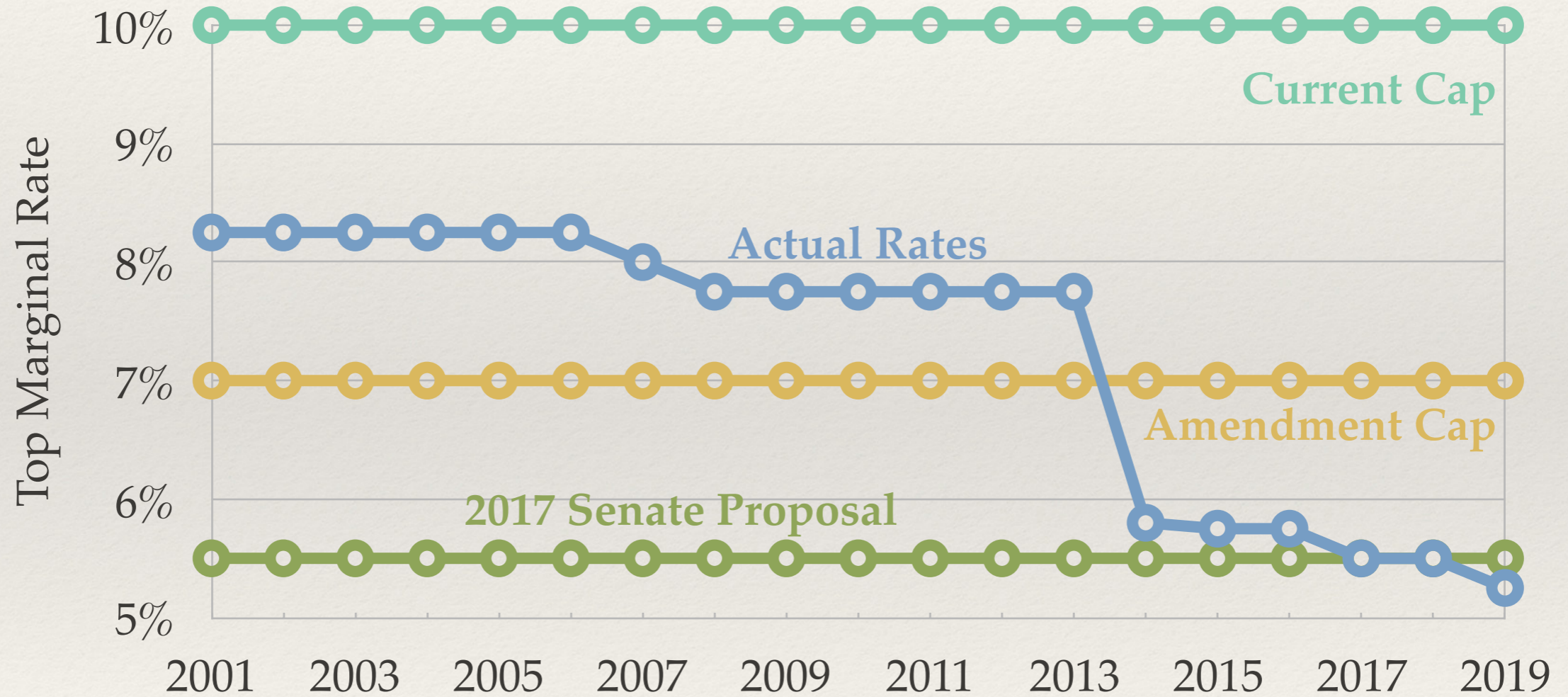
(Percent)



Source: "The Distribution of Major Tax Expenditures in the Individual Income Tax System", Congressional Budget Office, May 29, 2013, Figure 2.

NC Income Tax Cap Amendment

Top Marginal Rates in Context



Source: NC Department of Revenue, [Tax Rate Schedules](#)

The Cap is Bad for North Carolinians

- ❖ Revenue needs arise
 - ❖ Natural disasters, investment in infrastructure, etc.
 - ❖ Refunding programs previously cut too deeply, e.g., education
- ❖ The 2017 Senate proposal — pushed by AFP — would have prevented any income tax increases from today's historically low rates.
- ❖ The amendment cap, while not as draconian, prevents future return to historical income tax rates.
- ❖ Other ways to raise revenue — sales and excise taxes — are highly regressive, imposing the largest burden on the poorest among us.

Improving Our Tax System

Improving Our Tax System

Reframing

Current Framing

- ❖ Government is too big and inefficient, so cut spending
- ❖ Reduce tax rates to grow the economy and increased tax revenues will follow
- ❖ We can't afford ...
- ❖ How are we going to pay for ...?
- ❖ Entitlements for poor / sick / old people are killing the economy and causing unemployment

Who Gets “Welfare”?

Welfare for the Poor

Supplemental Nutritional Assistance Program	\$76B
Temporary Assistance to Needy Families	\$20B
Tax Expenditures Flowing to the Lowest Quintile	\$74B

Total \$170B

Welfare for the Wealthy

Tax Expenditures Flowing to the Highest Quintile	\$472B
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Sources:

- From "The Distribution of Major Tax Expenditures in the Individual Income Tax System", Congressional Budget Office, May 29, 2013, Table 1, the top ten tax expenditures sum to \$926B, with 51% going to the top quintile (\$472B) and 8% flowing to the bottom quintile (\$74B).
- SNAP and TANF data from "Welfare and the Federal Budget," Melissa Kearney, University of Maryland, July 25, 2017.

Reality

- ❖ Some government programs are good and some are not, just like some companies are good and others are not
- ❖ Tax expenditures are “entitlements” for the top quintile
- ❖ Tax expenditures fly under the radar
 - ❖ Politicians don’t have to vote for the “let’s pay high-earners \$150B to encourage them to buy stock” bill.
- ❖ We have to reframe the discussion

New Framing

- ❖ Taxes fund important services for the public and help people in our society who need help.
- ❖ Our tax system should distribute the burden fairly and should be transparent and understandable.
- ❖ Everyone pays, with the most fortunate among us sharing more of their income to support the services and investments that we all depend on as a country.
- ❖ As the most prosperous country in the world, by far, we can afford to provide quality education, healthcare, and economic opportunity for our citizens if we share the cost fairly.

Improving Our Tax System

Make More Progressive

Social Security Payroll Tax

- ❖ Eliminate the \$128,400 income cap on the payroll tax
- ❖ Would
 - ❖ Solve all Social Security financial issues
 - ❖ Make the Social Security tax proportional
 - ❖ Enable either increased benefits or broad reduction in the Social Security tax rate
- ❖ Later, make the Social Security tax progressive
 - ❖ Would allow further reductions in the broad rate
 - ❖ And/or, benefit improvements.

Sales Tax

- ❖ Sales taxes are inherently regressive.
- ❖ But they are ingrained in our business culture and would be hard to replace as a major funding mechanism for state and local governments.
- ❖ Instead,
 - ❖ Reduce sales taxes over time.
 - ❖ Compensate for lost sales tax revenue through increased state and local income taxes, which can be progressive.
 - ❖ Compensate for the regressive nature of sales taxes by increasing the amount and coverage of the earned income tax credit.

Subsidies Provided Through the Tax System

- ❖ Replace deductions with credits.
- ❖ Favor fully-refundable credits so all eligible people get the subsidy, regardless of income.
- ❖ Subsidize activities in which all income levels can participate.
 - ❖ Example: subsidize shelter, not mortgage interest
- ❖ Plan carefully any income-based phaseouts of credits to avoid disincentives to desirable behaviors.

Eliminate Preferential Treatment and Exclusions

- ❖ Tax capital gains and dividends as ordinary income
- ❖ Tax the value of employer-provided health insurance
- ❖ Tax net pension contributions and earnings
- ❖ *These changes would be wildly unpopular among the middle and upper class and would be viewed as tax increases. Offset those increases by broad-based tax reductions.*

Improving Our Tax System

Simplification

Reduce or Eliminate Tax-Based Subsidies

- ❖ Every subsidy is accompanied by rules, forms, and government intrusion.
 - ❖ Example: Charitable contributions
- ❖ All subsidies should appear in the budget as an appropriation, not provided as an (often hidden) tax break.
- ❖ Fully-refundable tax credits might remain a reasonable mechanism for implementing appropriated subsidies.

Eliminate Preferential Treatment

- ❖ Preferential treatment of certain income imposes enormous complexity across the tax code because of second-order interactions and inconsistencies

Eliminate Alternative Minimum Tax

- ❖ AMT is a parallel income tax system to compensate for high earners using excessive deductions and credits to avoid taxes.
- ❖ It is complex and is frequently “patched” by Congress.
- ❖ If we eliminated the tax preferences that caused the problems in the first place, we could eliminate the AMT.

Summary

- ❖ Our tax system is enormously complicated and unfair
- ❖ There are many vested interests in the current system
- ❖ Finding the political will to really “reform” it will be a huge challenge.
- ❖ I believe that changes will have to be made over time, packaged in a way that gives benefits to multiple constituencies simultaneously — to make progress we will have to compromise our principles.

More Info

I've blogged on some of this material:

<https://www.onthetopic.org>