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Tax Reform: Marginal Rates, Incentives, and More

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Introduction

Congressional momentum for tax reform has grown in recent years, with the Senate Finance and House Ways and Means Committees hosting numerous hearings and listening sessions around the country, publishing option papers and discussion drafts, and releasing comprehensive plans. The most recent of those was released today by Ways and Means Chairman Dave Camp (R-MI).

While political disagreement remains over the level of revenue that the tax code should produce, leaders on both sides of the aisle have indicated support for tax reform that would broaden the tax base and reduce rates. Bipartisan plans for tax reform, including that of the Domenici-Rivlin Debt Reduction Task Force, generally propose to broaden the base by limiting or eliminating tax expenditures—in the form of deductions, credits, and exclusions—and lowering statutory rates.[1] The magnitude of expenditures in the U.S. tax code is large enough that such a reform can be revenue-neutral (produce the same amount of revenue as the current system) or produce more revenue than the current system, even while lowering rates.

The fact that this type of tax reform can improve economic functioning is often discussed, but the reasons why are less frequently addressed. In this primer, BPC presents some of the fundamental concepts for considering tax reforms, related policy considerations, and the potential benefits of this general tax reform approach.

Tax Reform

The Base and the Rates

While the effects of income taxes on the economy are complicated and the subject of much debate, some basic concepts are quite intuitive. Understanding them is central to evaluating any tax reform proposal.

The tax base describes what is subject to taxation. For example, the base of a sales tax might include all goods sold at retail, or it might exclude food and medicine. For the federal income tax, all income, from whatever source, is taxed unless there is a specific exception in the federal tax code. But there are scores of these specific exceptions. Every deduction and exclusion—including commonly used tax expenditures, such as the deduction for mortgage interest, the deduction for state and local taxes, and the exclusion for employer-provided health insurance premiums—reduces the tax base.

Different measures of tax rates can be used to describe an individual's tax burden. Statutory rates are the ones with which most people are familiar. Those are the rates written into law—spanning from 10 to 39.6 percent—that apply to specific ranges of income. In addition to the federal income tax, federal payroll taxes and state and local income and sales taxes increase the total tax burden on workers.

A concept closely related to statutory rates is the marginal tax rate, which describes the percentage of income that the government would collect on an additional dollar of income earned by a person or another taxed entity, such as a corporation. Often, the marginal tax rate for a taxpayer is the same as the cumulative statutory rate (from the various taxes cited above) for their highest income bracket. However, the two diverge in some cases due to hidden marginal rates or certain tax expenditures that affect marginal rates, both of which will be described below.

Middle-class Americans typically face a top statutory federal income tax rate of 15 or 25 percent, while those with the highest adjusted gross incomes—more than $400,000 for individuals or $450,000 for joint filers—face 39.6 percent rates beginning in 2013.[2] An individual's top statutory and marginal tax rates are both usually significantly higher than his or her average—or "effective"—tax rate, the total dollar amount of taxes paid divided by total income. The effective tax rate is lower than the marginal tax rate because of the progressive tax rate schedule, under which the first dollars of income are taxed at lower rates, and also because of tax expenditures. For example, a single taxpayer who earns $30,000 in 2013 and claims the standard deduction is in the 15 percent tax bracket, but the first $10,000 of income is exempt from income tax because of the standard deduction and personal exemption, and the next roughly $10,000 is taxed at a 10 percent rate. As a result, the average effective tax rate is only about 8 percent. (It would be lower still if the taxpayer qualified for tax credits or other deductions or exclusions.)

Many economists focus on marginal tax rates because the percentage of an additional dollar of income that taxpayers are able to keep would be expected to have the most influence on incentives to earn additional taxable income or to engage in various forms of tax avoidance—at least for the hypothetical fully informed, rational taxpayer. Hence, tax reform proposals with a goal of improving economic efficiency without reducing tax revenue often involve combining reduced marginal rates with changes that would broaden the tax base.[3]

Differential Rates, Distortion, and Tax Avoidance

One of the primary justifications for tax reform is to reduce economic inefficiencies caused by differential rates that incentivize people to avoid taxation by changing their behavior. Taxing income from different sources at different rates can distort economic decisions by encouraging people to choose to receive or consume their income in different ways than they might otherwise. This may be the explicit purpose of a tax subsidy, such as with the charitable deduction, which is meant to encourage giving. In many cases, however, there also exist unintended negative effects related to tax avoidance that result in sub-optimal outcomes. For example, because employer-provided health insurance, unlike cash wages, is not subject to federal income or payroll tax, some compensation shifts from taxable wages to untaxed health benefits, increasing the generosity of health benefits and creating a variety of effects in the health insurance market.[4]

Additionally, differences among tax rates on various forms of income also create opportunities and incentives to receive income in different forms purely to avoid taxation. One prominent example is the tax treatment of investment income. Because dividends and capital gains are taxed at lower rates than ordinary income, the managers of businesses have an incentive to design compensation packages that take the form of capital gains, if possible. This partly explains why managers of investment partnerships often try to construe compensation for their work as carried interest, which is taxed at the lower capital gains rates. Likewise, owners of S-corporations have a potential incentive to try to reduce their salaries and to instead increase business profits, which are not subject to payroll tax. In this manner, tax preferences can affect the decisions of both individuals and corporations.

Tax preferences may also encourage the shifting of investment into different forms. The exclusion for municipal bond interest encourages lending to state and local governments, while the mortgage interest deduction encourages investment in owner-occupied housing.

These shifts in income and consumption often create inefficiency, especially when individuals over-invest in certain investments because their returns are buoyed by tax preferences. For example, many economists believe that the mortgage interest deduction causes individuals to hold more wealth in their homes than would be the case in a properly balanced investment portfolio. Sometimes, the inefficiency caused by tax incentives is justified by equity concerns or policy goals, but other times it is not.[5]

Furthermore, in some cases, a given set of policy goals could be achieved through other, more-efficient means than those which are currently used. For example, some have proposed replacing the exclusion for municipal bond interest with a credit that would be advanced to municipal bond issuers, which would reduce revenue lost from the tax expenditure while ensuring more of its benefits accrue directly to state and local governments. An important point to note is that lowering rates can reduce the distortion caused by tax expenditures (e.g., those that remain in the code after reform), because the expenditures save individuals and businesses less money when rates are lower.[6]

In addition, over the long run, the economy suffers from diverting resources toward complex tax-avoidance schemes—resources that could otherwise be put toward productive economic activity. Large amounts of money, for instance, are spent each year on accountants who help individuals and businesses minimize their tax burdens. By eliminating or limiting tax breaks, tax reform can reduce these inefficiencies.

Work Incentives

The impact of taxes on incentives to work reflects two different effects, commonly referred to by economists as the income and substitution effects. One effect of higher marginal tax rates is that someone who wants to maintain his or her previous standard of living will have to work more hours in order to earn the same level of after-tax income. This is called the "income effect" and prompts the individual to work more hours or seek higher wages. However, the substitution effect works in the opposite direction. If marginal tax rates are higher, then after-tax wages are lower, and working becomes relatively less attractive compared with alternatives, reducing the incentive to spend more hours at work.[7]

Economists often discuss the substitution effect in reference to the trade-off between paid work and alternative uses of time—which could include, for example, working and paying for child care versus staying home for more hours to take care of one's own children, or continuing to work full-time versus starting a phased retirement. The latter options might become more attractive when a worker is taking home less pay from working an additional hour (and vice versa). Another trade-off could be among working part-time and going to school part-time, versus working full-time, versus continuing one's education full-time.[8]

The income and substitution effects typically counter each other; the net effect of any tax change has to be determined through observation, which is what many research studies attempt to do. Tax reform has the potential to affect work incentives, but ascertaining the impact of reform on the labor supply can be complex, as some tax expenditures affect marginal rates. Basically, any tax subsidy that tends to grow with earnings effectively reduces marginal tax rates. For example, the state and local income tax deduction does this as each additional dollar earned is subject to state income tax, which is in turn deductible for federal income tax purposes.

Ideally, tax reform that broadens the base and lowers rates would increase work incentives without decreasing revenue. Some economists argue that this is theoretically possible. If individuals anticipate taking home more of every additional dollar earned, then they have increased incentives to work to earn that dollar through the substitution effect. In most cases, the income effect would offset this increased incentive to work, but if tax reform is designed so that it lowers marginal rates but does not affect average rates, then individuals' incomes would remain unchanged—meaning that the income effect, which discourages work when income increases, would be zero. Under this hypothetical scenario, the substitution effect would prevail. In practice, this may be unachievable because it is very difficult to lower marginal rates and broaden the base without changing average rates. As such, other economists argue that this type of tax reform cannot improve work incentives.

The effects of a particular reform also may vary among different members of a household, introducing additional complexity. Furthermore, most taxpayers do not carefully make these calculations when evaluating decisions about whether to perform additional work. As a result, the effect on work incentives of a tax reform that broadens the base and lowers the rates must be evaluated as a whole, and the research so far does not suggest that large work effects would be likely to occur.

Hidden Marginal Rates

The statutory federal income tax rates are not the only levers that policymakers have at their disposal if they desire to change marginal tax rates as part of comprehensive tax reform. Embedded in the code are hidden rates that arise due to phase-outs of various provisions. For example, as part of the "fiscal cliff" agreement at the beginning of 2013, Congress reinstated the Personal Exemption Phase-out (PEP) and the "Pease" restriction on itemized deductions for high-income taxpayers.[9] Phasing out deductions over a range of incomes effectively increases the marginal tax rate within that range. In the case of Pease, the marginal top income tax rate becomes 40.79 percent (compared with the top statutory rate of 39.6 percent).[10]

Lower- and middle-income Americans are also affected by hidden marginal rates. For example, the Earned Income Tax Credit (EITC) provides support to low-income working Americans, especially those with children, and it is refundable, which means that the credit's value can exceed an individual's income tax liability. The EITC increases with each dollar of earned income from zero to $13,430 for workers with two or more children. This creates a very strong incentive for Americans in this income range to both participate in the workforce and also to increase their working hours. However, the opposite effect occurs as the credit phases out, beginning at $17,530 of earnings for a single working parent (or $22,870 for joint filers). During this phase out, the effective marginal tax rate could be quite high. For instance, a 2010 study from the Richmond Federal Reserve Bank found that a married couple with two children earning $41,000 would face a marginal tax rate of 36 percent due in large part to the EITC phase-out, a rate that at the time was even higher than the top statutory federal income tax rate.

Given the EITC's positive contributions, few would support abolishing the credit with no replacement, but its case exemplifies a common trade-off: elements of the tax system that promote equity sometimes contain aspects that reduce efficiency, increase complexity, and are susceptible to high rates of error and fraud. In some instances, however, approaches that are potentially more efficient and streamlined could also lead to an equitable result. For example, the Domenici-Rivlin Task Force recommended the replacement of the EITC, the child tax credit, personal exemptions, and the standard deduction with a refundable earnings credit and a refundable child tax credit that would not phase out. The proposed earnings credit would avoid the hidden marginal tax rate issue that arises in the phase-out range of the current EITC (and would also vastly simplify eligibility for the credit), potentially increasing work incentives for those in the phase-out range while maintaining support for low-income earners.[11]

Progressivity

While considering changes to the tax code that affect marginal rates, policymakers must evaluate the net effect on progressivity of any tax reform proposal. The U.S. federal income tax is generally progressive; the 20 percent of taxpayers with the lowest incomes pay approximately 0.8 percent of their income in federal income tax, while the 20 percent with the highest incomes pay roughly 24.5 percent, according to the Tax Policy Center.[12] Tax reform can be designed in ways that would increase, decrease, or maintain the progressivity of the federal individual income tax.

Progressivity is determined by the combination of the rate structure and the base. Certain kinds of differential rates, such as low rates for investment income or itemized deductions, disproportionately (and often overwhelmingly) benefit high-income taxpayers. Some tax expenditures, such as higher-education tax credits, confer the greatest benefit (as a percentage of income) to middle-income taxpayers. As mentioned earlier, others, including the EITC, squarely target low-income working families. Exclusions, such as the one for employer-provided health insurance, provide relatively similar benefits as a percentage of income to low-, middle-, and high-income Americans; although those with very high incomes may benefit proportionally less because their health care is a smaller share of their earnings, and much of their earnings are not covered by Social Security payroll taxes.[13]

Adjustments to the rate structure and changes to the tax base could be made to achieve the desired level of progressivity; generally, the tax base should be chosen on the grounds of equity and efficiency, and the tax rate schedule should subsequently be chosen to achieve the desired overall level of progressivity and sufficient revenues.[14] Included in that calculation must be the reality that a fundamentally reformed tax system will result in “winners and losers”—some people’s tax liabilities will go up while others’ will go down—and the tax rate schedule will partially determine how many winners and losers there will be at different points in the income scale.

Revenue

Because marginal tax rates can be adjusted up or down, income tax reform can essentially achieve whatever level of revenue is desired. This is determined by the balance between the base broadening that can be agreed to and the statutory tax rate adjustments that are chosen. For any given level of desired revenue, elimination or curtailment of additional tax expenditures will enable lower marginal rates and—depending on the particular changes to tax expenditures—potentially increase economic efficiency, as well. The key challenges are to agree on the targeted amount of revenue, the desired level of progressivity, and which specific tax preferences to limit or scrap. The marginal tax rate structure can then be chosen to achieve all of those objectives to the highest possible degree. Broadly, the case for tax reform is that, for any given level of revenue, there are some ways to raise it that entail more distortion and some that cause less; a more-efficient code will be better for economic growth, reduce opportunities for tax avoidance, and can also simplify filing for taxpayers.

The Corporate Income Tax

While the managers of corporations face different choices than individuals, business decisions are also affected by marginal tax rates. The top U.S. corporate rate is higher than those of other large economies, increasing incentives to recognize income in other countries, if possible. The numerous strategies to change where income is recognized—which can be substantially independent of where employees work, where physical capital and production are located, or where sales are made—have recently received significant attention from the media and Congress. Like the individual tax code, the corporate income tax also has a variety of deductions and credits, which could be limited or eliminated as part of a base-broadening, rate-reducing tax reform. Corporate income tax reform is complicated by two challenging issues that are beyond the scope of this primer: the taxation of foreign-source income and the proliferation of pass-through entities that are not subject to the corporate income tax.

Taxation of Investment Income

Certain kinds of investment income—such as dividends, long-term capital gains, and interest on municipal bonds—are subject to lower individual income tax rates than ordinary income, and investment income from retirement savings (including defined benefit pensions, 401(k)s, and IRAs) is usually tax-deferred (meaning that taxes are not paid until retirees receive distributions).

There is substantial controversy about the best approach to taxing investment income. Some argue that marginal rates for capital gains and dividends should be lower than ordinary income for several reasons: to reflect that, in many cases, such income has already been taxed at the corporate level; to reduce the tax penalty on saving; and because at high rates, capital gains revenues may falter as investors are less likely to sell assets with accrued gains.[15] Others, including the Domenici-Rivlin Task Force, recommend that the taxation of investment income be set at the same rates as that of ordinary income under a reformed tax system with a lower top rate, which would reduce inefficiency in allocations and increase progressivity.[16]

Taxing Income vs. Consumption

All of the analysis above is focused on reforms to the current income tax code. Many economists, however, support raising a greater share of total revenues through various consumption taxes—such as sin taxes (e.g., on alcohol or cigarettes), a carbon tax, or a broad-based sales (such as a value-added) tax—or even replacing the income tax with the Hall-Rabushka flat tax, the Bradford X tax, or the personal expenditures (consumed-income) tax.[17] Those advocates note that income taxation creates an economic distortion by imposing higher effective tax rates on savings for future consumption than on income consumed today because the income earned on an individual's savings (e.g., interest, capital gains, dividends) is also taxed. Relative to a tax on consumption, therefore, an income tax system reduces incentives to save. One counter-argument made by opponents is that consumption taxes would be less progressive than the current tax system, although the X tax and the personal expenditure tax could be designed to be roughly as progressive as the current system.

A full discussion of this issue is beyond the scope of our primer, but the split of federal revenues between income and consumption tax revenue is an important question for policymakers. Even if a move toward consumption taxation is not on the table, it is necessary to consider how measures to broaden the income tax base affect the saving penalty discussed above.

Conclusion

There are many views about what the relative importance of the many goals of tax reform should be, including revenue sufficiency, changing the distribution of the tax burden across income levels (progressivity), improving administrative simplicity, and reducing economically distorting incentives in the tax code. A well-designed tax reform program, however, can be pro-growth while also improving efficiency, equity, and administrative simplicity compared with the status quo.

In a revenue-constrained world (and one with elevated projections of long-term debt), reducing marginal tax rates will be possible only with tax reform that broadens the income base. A well-designed reform could promote economic growth with a broader base and lower rates, but in doing so, should account for issues of equity, administrative simplicity, and adequacy of revenue. The reform should also address special issues related to the corporate income tax and investment income. These are difficult and complex challenges, which is why major tax reforms are rare. The last one took place more than a quarter-century ago, in 1986, when bipartisan leadership ushered legislation to curtail tax breaks and reduce marginal rates to the signing pen of President Ronald Reagan. If 2014, just past the one-hundredth anniversary of the modern federal income tax, is to be the year of the next major tax reform, similar bipartisan leadership and cooperation will be essential.

End Notes

[1] See: Domenici, Pete, and Rivlin, Alice (2012) Domenici-Rivlin Debt Reduction Task Force Plan 2.0. Bipartisan Policy Center, December. Available at: http://bipartisanpolicy.org/library/report/domenici-rivlin-debt-reduction-task-force-plan-20.

[2] Until last year, that rate was 35 percent, but it was increased by the American Taxpayer Relief Act of 2012, commonly known as the "fiscal cliff" deal.

[3] A broader tax base does not always translate into a more efficient means of taxation. For example, a small number of states levy a gross receipts tax on businesses instead of an income tax. While a gross receipts tax has a larger base (since it is usually applied to all revenue, instead of profits), that form of taxation can cause significant distortions, particularly for high-volume, low-margin businesses. Similarly, income taxes traditionally have larger bases than sales taxes, but are generally considered to be less economically efficient.

[4] Many economists have argued that the exclusion has contributed to unsustainable health care cost growth. See: Gruber, Jonathan (2010) *The Tax Exclusion for Employer-Sponsored Health Insurance*. NBER Working Paper 15766, February. Available at: http://www.nber.org/papers/w15766.

[5] For this reason, starting from a "clean slate" on the income tax code and weighing the trade-offs of each tax expenditure that is added back in—the approach recently outlined by Finance Committee Chairman Max Baucus and Ranking Member Orrin Hatch—can lead to fruitful and necessary discussions. See: Baucus and Hatch (2013) "Next Steps on Tax Reform." Letter to the Senate Finance Committee, June 27. Available at: http://www.finance.senate.gov/imo/media/doc/06272013%20Call%20for%20Input%20on%20Tax%20Reform1.pdf.

[6] See: Marron, Donald, and Toder, Eric (2012) *How Big is the Federal Government?* Urban Institute, March. Available at: http://www.urban.org/publications/412528.html.

[7] The incremental distortionary effects of taxation are lower at lower tax rates: raising marginal rates from 40 percent to 45 percent creates less distortion than an increase from 45 percent to 50 percent.

[8] For an individual's decision about whether to participate in the workforce, his or her marginal tax rate for an additional hour of work can be less important than the average tax rate, which provides the average take-home pay per hour worked.

[9] The Personal Exemption Phase-Out, or PEP, reduces the maximum personal exemption from income taxation for people with annual income more than a set amount, which varies by marital and filing status. The maximum personal exemption, which starts at $3,900, is reduced at a phase-out rate, which again depends upon marital and filing status, until it hits zero at the "completed phase-out" level of income for that person.

[10] The "Pease" restriction on itemized deductions phases out the maximum value of itemized income tax deductions, which include, among others, the charitable deduction, mortgage interest deduction, and state and local property tax deduction. The maximum deduction is reduced, or "phased out," by 3 percent of every dollar by which a filer's income exceeds a certain threshold (also varying by marital and filing status).

[11] Empirical research has found the EITC's phase-out (i.e., a hidden marginal rate) to have little effect on work incentives, and the credit has increased labor force participation among low-income individuals with children. Nonetheless, the EITC has complicated eligibility rules that result in many improper payments and also deter eligible recipients from claiming benefits. Streamlining this credit by basing it directly on earnings and guaranteeing automatic eligibility would improve administrative simplicity and ensure that taxpayers do not have to wait until filing season to benefit.

[12] Although the federal income tax is quite progressive, many other taxes paid by Americans are not. The overall tax burden is still progressive for most U.S. households, but not as progressive as the federal income tax code.

[13] See: Toder, Eric, and Baneman, Daniel (2012) *Distributional Effects of Individual Income Tax Expenditure: An Update*. Tax Policy Center, February. Available at: http://www.taxpolicycenter.org/UploadedPDF/412495-Distribution-of-Tax-Expenditures.pdf.

[14] While considering tax reform and progressivity goals, policymakers should also be mindful of the overall progressivity of the nation's tax system, which also includes payroll taxes, corporate income taxes, excise taxes, and estate and gift taxes. Adjusting the proportion of federal revenues collected from various types of taxes will change the degree of progressivity in the overall system.

[15] With the intent of reducing or eliminating the income tax's penalty on savings relative to consumption, some economists also propose implementing a tax on consumption in exchange for reducing rates on investment income.

[16] See: Burman, Leonard (2012) “Tax Reform and the Tax Treatment of Capital Gains.” Testimony before the House of Representative’s Ways and Means Committee and the Senate Finance Committee. September 20. Available at: http://www.urban.org/publications/904606.html.

[17] These proposals are beyond the scope of this primer, but more information on them is available at: Hall, Robert E., and Rabushka, Alvin (1995) *The Flat Tax*, 2nd ed., Stanford, CA: Hoover Institution Press; Carroll, Robert, and Viard, Alan D. (2012) *Progressive Consumption Taxation: The X Tax Revisited*, Washington: AEI Press; Seidman, Laurence S. (1997) *The USA Tax: A Progressive Consumption Tax*, Cambridge: MIT Press.