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TAX REFORM: HISTORICAL TRENDS IN INCOME AND REVENUE

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CONTENTS

OPENING STATEMENTS

WITNESSES

ALPHABETICAL LISTING AND APPENDIX MATERIAL

TAX REFORM: HISTORICAL TRENDS IN INCOME AND REVENUE

THURSDAY, DECEMBER 2, 2010

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Bingaman, Wyden, Schumer, Nelson, Menendez, Grassley, Hatch, Snowe, and Enzi.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Lily Batchelder, Chief Tax Counsel; John Merrick, Tax Counsel; Mary Baker, Detailee; Andrew Fishburn, Detailee; and Ryan Abraham, Professional Staff. Republican Staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Tony Coughlin, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

A tax system expresses a society's values. America is always changing; that is one of our strengths. That change also means that periodically we need to consider whether our tax system continues to express the values that we want to put first.

To consider where we want our tax system to go, we need to understand where we are and understand where we have been. In September, the committee kicked off a series of hearings on tax reform. We examined the environment that produced the 1986 tax reform. Today, we look at historical trends in income and in taxes. This will give us a useful background as we roll up our sleeves for tax reform.

First, we need to examine where Federal revenue comes from. The composition of Federal revenue has changed significantly since World War II. As a percentage of total revenue, Social Security taxes have increased and corporate and excise taxes have decreased.

For example, in 1950, corporate income taxes provided 30 percent of Federal revenue; by 2009, they made up only 7 percent. In the 1950s, excise taxes produced 19 percent of Federal revenue, and by 2007 they comprised only 3 percent. Over the same period, social insurance taxes like Social Security and Medicare taxes more than quadrupled. In 1950, they provided about 10 percent of Federal receipts; by 2009, they generated 42 percent.

Why has the composition of Federal revenues changed so dramatically? Should we be concerned that the share of revenue raised by the corporate income tax has declined by more than 75 percent? Is that a result of an increasingly global economy? Is it because the corporate tax base is too narrow? Or is it linked to the fact that the share of business income, subject to the corporate income tax, as opposed to the share of tax on a pass-through basis, has fallen from about 70 percent to about 43 percent over the past quarter of a century?

Is it a cause for concern that fewer businesses are structuring themselves as corporations? Did more businesses structure themselves as corporations—I am referring to C corporations—in the past because corporations were used as tax shelters, or was it because we now tax corporations too heavily? Answers to questions like these will help us know where we are going on corporate tax reform.

Second, we need to understand the distribution of income in Federal taxes. In 1980, the richest 1 percent of Americans received about 9 percent of total income; by 2006, the share more than doubled, to about 19 percent. Meanwhile, the share of total income received by the 20 percent of households with the lowest incomes fell from about 6 percent to about 4 percent.

Over this period, average tax rates fell for all households, including the richest 1 percent. The share of Federal taxes paid by the top 1 percent grew, but this group's share of income grew even faster. As a result, over the past quarter of a century, the share of after-tax income received by the richest 1 percent has doubled, from about 8 percent to 16 percent. Meanwhile, the share of after-tax income declined for almost all other households. For example, the share of the middle fifth of taxpayers fell from about 16 percent to 14 percent.

Why are these trends occurring? Are highly paid workers working harder relative to other workers than they did in the past, or are changes in the economy failing to benefit low- and middle-income workers? Has the tax code kept up with these broad changes in the economy? We need to understand how tax burdens are allocated and how they have been allocated in the past.

Third, we need to look at how America compares with our global competitors. We need to have a tax code that encourages companies to locate and grow in America. We need to help to create American jobs. We need to ensure that America maintains our global competitiveness, enhances it, and increases it. American companies will win when competing with foreign companies, provided they compete on a level playing field. We also need to ensure that the tax code promotes the growth of our economy and the creation of jobs.

I often hear that we need to change the tax code to level the playing field for American companies. Today we will ask how our tax system compares with our major competitors.

So let us consider the way that the American economy has changed, let us think about whether we need to change our tax system as well, and let us seek to ensure that our tax system expresses the values that we as a society want to put first.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you, Mr. Chairman, for this very important hearing.

With so many extremely important tax matters before Congress, it is good to take a step back and think about tax policy broadly. When I use the term "tax reform," I mean that term to be revenue-neutral. Tax reform, to me, means a restructuring of the tax code so as to decrease inefficiencies and decrease complexities. It does not mean a grab of more revenue by the Federal Government. So revenue neutrality means setting a target of revenue that ties to current tax policy.

Why do we not like high taxes? One is that the economy is growing globally outward. The Fortune 500 is no longer almost completely comprised of U.S. companies. U.S. companies now must compete with foreign companies. Thus, if average tax rates that U.S.-headquartered companies are subject to are higher than the average tax rates of foreign-headquartered companies, we should not be surprised to find that fewer and fewer global businesses are headquartered in the United States.

Furthermore, if the marginal tax rate that a U.S. business has is higher than that of a foreign business, we would find that the cost of capital for U.S. businesses would be higher than for foreign businesses, obviously putting the U.S. businesses at a competitive disadvantage.

From those conclusions regarding America's position in the global economy, it follows that efforts to reduce complexity and tax burden on flow-through businesses need to be enhanced, not reversed. Most of the business growth since the 1986 Tax Act has been in the flow-through sector; raising marginal rates and applying complex business tax rules to this sector will retard that growth. Not only can high taxes fund a too-large Federal Government, but also they may harm the private sector and make the free market not so free.

Income taxes create a disincentive from earning taxable income, thus distorting decision-making and stifling the economy. I believe this to be true, no matter what the level of taxation is. Obviously some minimum level of revenue is necessary for the Federal Government, and so some minimum level of taxation is necessary.

But to raise a given amount of revenue, there are various harmful ways to raise it. On the other hand, there are ways that only cause minimal harm to the free market. Statistics show that the average tax rate is, for a given set of taxpayers, important. Even more important, though, than the average tax rate are the marginal tax rates.

Marginal tax rates show what a taxpayer will pay on the next dollar of income. Most decisions are made on the margin. That is, generally taxpayers will not decide, in response to high taxes, to simply not work. Admittedly that does happen some, especially in the case of a spouse rejoining the workforce. Most people need income, and thus most people need to work. But what is common is making the decision whether to do an extra or marginal amount more of work to make marginally more income.

Too high a marginal tax rate can disincentivize work. It is fundamental to understand this, yet back in July of this year this committee actually had a witness who was very okay—yes, okay—with the idea of a 90-percent marginal tax rate. He was of the opinion that, since such a taxpayer could keep 10 percent of the return on his effort, it was still worth his while to make the effort.

But to me, that is nonsense. If one can only keep 10 cents for every dollar of income, a person will probably decide that he does not need the additional income after all, and maybe it is just a good time to take a vacation. Or instead of earning additional taxable income to, say, hire contractors to build a garage next to your house, high marginal tax rates could lead you instead to build the garage yourself.

Let us hypothetically suppose that a flat income tax rate with a 20-percent tax rate raised sufficient revenue for the government. Of course, such a flat rate structure could be made progressive by getting rid of the flat 20-percent rate and having a 10-percent rate for taxable income below a certain amount and a 30-percent tax rate for taxable income above such amount.

Note that for people making a low enough income, their marginal tax rate would be 10 percent rather than 20 percent. This would increase such persons' incentives to make additional income. However, for higher-income people, they would find their incentive to earn more money has gone down. That is, their marginal tax rate would no longer be 20 percent, but would be 30 percent.

So it may seem that the two sets of rate structures somehow net out. That is, under the progressive rate structure with tax rates of 30 percent and 10 percent, some taxpayers have more incentive—as compared with a 20-percent flat rate—to make additional income, but others would have less incentive.

As far as incentive effects to earn additional income, the two rate structures may net out, but obviously that is not telling the full picture. The full picture is this: many taxpayers who would be in the 30-percent tax bracket may have income that they think they do not need. They have their needs met without additional income, so they may easily decide not to earn more. Of course, for lower-income workers, they often need the additional money, and so a lower marginal rate, 10 percent instead of 20 percent, does not as much encourage additional work because they likely already wanted and needed additional income.

On a related point, on July 14, this committee held a kick-off tax reform hearing. At that hearing, I spoke about a taxpayer named John, a real-world case, where John had a high marginal rate of 30 percent, but actually paid no tax at all, and even received a small check from the government. That is, John had a high disincentive for making additional income, but the government got no more money from John—the worst of both worlds.

One final word, Mr. Chairman. When it comes to the topic of tax reform, we will inevitably hear a lot of statistics. Of course, that is good and proper, given the subject matter. However, it is also worth keeping in mind what a great conservative leader, Benjamin

Disraeli, had to say on this topic. He said, "There are three kinds of lies: lies, damned lies, and statistics." That is worth keeping in mind, as there are a lot of statistics we will undoubtedly hear on tax reform.

In particular, the United States has changed demographically. There are fewer joint filer households, and many more singles and heads of households. That demographic change has tended to make joint filers look so-called richer than they would otherwise, simply because of the mechanics of the measurement. As a result, we get a lot of studies showing a growing income cap with no accounting for this demographic shift.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Let us turn to our witnesses. We are very honored to have all three of them here. First, Doug Elmendorf, Director of the Congressional Budget Office. Thank you very much, Dr. Elmendorf. Tom Barthold, Chief of Staff for the Joint Committee on Taxation. Thank you, Dr. Barthold. Also, Mark Mazur, Deputy Assistant Secretary of the Treasury for Tax Analysis. We thank you, sir, for also attending.

Our usual practice, as you all know, is to put your statements in the record and for you to summarize them in roughly 5 minutes. We will give you a little leeway, but do not take advantage of that. [Laughter.] Close to 5, please.

Dr. Elmendorf?

STATEMENT OF DR. DOUGLAS ELMENDORF, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Dr. ELMENDORF. Thank you, Chairman Baucus, Senator Grassley, and members of the committee.

The CHAIRMAN. And I might note, this is a very august panel, because all three of you are doctors, so that means you all got Ph.Ds.

Dr. ELMENDORF. As my children would say, not the useful kind of doctor. [Laughter.] But we appreciate it nonetheless.

The CHAIRMAN. It all means you know something.

Dr. ELMENDORF. My testimony today addresses three issues in tax policy: the revenues collected by the Federal Government, how taxes affect economic activity, and who bears the burden of the tax system. Other aspects of the tax system, such as its complexity, are also important but are not included in my testimony.

Let me summarize the written remarks you have received, beginning with revenues. This picture is the second exhibit from the written testimony. Over the past 40 years, Federal revenues have ranged from nearly 21 percent of GDP in fiscal year 2000 to less than 15 percent in fiscal years 2009 and 2010.

The CHAIRMAN. If I might, Dr. Elmendorf, I assume that is in your materials here. What page?

Dr. ELMENDORF. Yes. That is Exhibit 2.

The CHAIRMAN. Two?

Dr. ELMENDORF. In the prepared testimony, Mr. Chairman, that is on page 7, I believe.

The CHAIRMAN. Seven?

Dr. ELMENDORF. I am sorry. Six. Page 6.

The CHAIRMAN. Six? All right. Thank you. I have it.

Dr. ELMENDORF. So Federal revenues have averaged 18 percent of GDP over the past 40 years. Under current law, revenues will rise significantly from their recent low relative to GDP as the economy recovers from the recession and the tax reductions enacted in 2001, 2003, and 2009 expire.

We project that, under current law, Federal revenues will reach 21 percent of GDP in fiscal year 2020, just above their peak share 10 years ago. We also project that, under current law, Federal spending will reach nearly 24 percent of GDP in 2020, slightly lower than the peak level of almost 25 percent in fiscal year 2009, but well above the average of roughly 21 percent over the past 4 decades.

Compared with that historical experience, the components of Federal spending that are projected to be unusually large relative to GDP by 2020 are the expenditures for Social Security, and especially the Federal health programs. Other non-defense spending is projected to roughly equal its historical share of GDP, and defense spending is projected to be a smaller share of GDP than its average over the past 40 years.

Therefore, even with a projected substantial increase in revenues under current law, deficits between 2015 and 2020 will range between 2.5 and 3 percent of GDP. If the Congress extended most or all of the 2001 and 2003 tax cuts and made no other changes to taxes and spending, revenues would be lower and deficits would be significantly larger.

The CHAIRMAN. I am sorry. So that assumes these tax cuts are extended or not extended?

Dr. ELMENDORF. No. This is based on current law, the rules that govern CBO's baseline. Under current law, the deficit in 2020 would be about $700 billion. If all of the 2001 and 2003 tax cuts were extended and the AMT is indexed to inflation, then the deficit would be about twice as large in 2020, about $1.4 trillion.

The CHAIRMAN. All right.

Dr. ELMENDORF. Let me turn, next, to the effect of taxes on economic activity. Taxes raise the price of taxed activities and therefore lower the relative price of other activities. In particular, the income tax and payroll tax reduce the returns from working, and the income tax reduces the returns from saving. One measure of the effect of taxes on the returns from working and saving is, as Senator Grassley noted, the marginal tax rate, that is, the tax paid per dollar of extra earnings or dollar of extra income from savings.

In this slide, which is Exhibit 4 from the written testimony on page 9, the highest marginal income tax rate, the rate that applies to the highest tax bracket, was as high as 70 percent as recently as 1980, although a lower maximum rate applied to earnings in that year.

Since 1988, the highest marginal income tax rate has ranged between 28 and 39.6 percent. For a representative family of four with median income—and this picks up the next slide, Exhibit 5 from the testimony—the marginal tax rate on earnings, combining the rate for both income and payroll taxes, has remained at about 30 percent since the mid-1980s.

Provisions in the tax code can also affect economic activity by subsidizing certain types of spending. Revenues foregone because of certain special features of the tax code are known as tax expenditures. The two largest tax expenditures—and this now turns to Exhibit 7 on page 12 of the testimony—are the deductions for mortgage interest on owner-occupied residences and the exclusion of employers' contributions for health insurance premiums from the individual income tax.

There are significant corporate tax expenditures as well. Tax expenditures have helped to accomplish various goals, but, because they reduce the base on which tax rates apply, tax rates must be higher to collect the same amount of revenues that would be collected in the absence of those subsidies.

Third, let me turn to the tax burden and who bears it. Households generally bear the economic cost, or burden, of the taxes they pay directly, but also taxes paid by businesses. One measure of the tax burden is the average tax rate, which simply equals taxes paid as a share of income. Federal taxes are progressive—this is from Exhibit 11 in the prepared testimony on page 17—meaning that average Federal tax rates generally rise with income.

In 2007, households in the bottom fifth, or quintile, of the income distribution paid about 4 percent of their income in Federal taxes, while the middle quintile paid 14 percent, and the highest quintile paid 25 percent.

Individual income tax, in particular, has average tax rates that rise rapidly with income. Payroll taxes have average tax rates that vary little across most income groups, but fall for the highest quintile because earnings above a certain threshold are not subject to Social Security payroll tax and because earnings represent a smaller share of total income for that highest quintile.

The average social insurance tax rate is higher than the average individual income tax rate for all income groups, except to the highest quintile. Between 1979 and 2007, the average tax rate for Federal taxes declined for all income groups. The share of taxes paid by the top fifth of the population grew sharply between 1979 and 2007. Almost all of that growth can be attributed to an increase in that group's share of before-tax income.

If one turns in the testimony to Exhibit 17, you can see the share of total before-tax income and total Federal tax liabilities in 2007. In 2007, households in the highest quintile earned 55 percent of before-tax income and paid almost 70 percent of Federal taxes. For all other quintiles, the share of Federal taxes was less than the share of income.

I will stop there. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Dr. Elmendorf, very, very much.

[The prepared statement of Dr. Elmendorf appears in the appendix.]

The CHAIRMAN. Dr. Barthold?

STATEMENT OF DR. THOMAS A. BARTHOLD, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, DC

Dr. BARTHOLD. Good morning, Mr. Chairman and Senator Grassley. Your staff asked me to provide a descriptive overview of the Federal tax system over the past 35 years, and our staff has provided you with the description of the Federal tax system over that period in JCX–51–10, which we offered as our formal testimony. I will offer a very brief review.

The Federal tax system is comprised of five components. Figure 6, which is on page 69 toward the back of the hearing pamphlet, is on the chart over here to my right. We have the individual income tax, we have the employment payroll taxes, we have the corporate income tax, estate and gift taxes, and excise taxes.

Now, the key elements of any tax, of course, are defining the tax base and determining the tax rates, so I will give you just a brief review of some of the history of that. We will turn to the next figure, which is our Figure 1 on page 6 of the document.

What Figure 1 does—it is with respect to the individual income tax—is it describes the evolution of the top bracket of the individual income tax over time. So what this figure just captures for you is the top marginal tax rate and the entry point in terms of real, constant 2010 dollars of income at which that marginal tax rate applies.

In terms of reading the chart, the larger the bubble means a greater amount of income. So what you basically see is, since 1975 to today, that the bubbles have dropped down to the right and gotten smaller, which means that the marginal tax rate for the top tax bracket has declined over time and that the entry point of the top tax bracket has declined in real-dollar terms. That is the top end.

Figure 2, which is on page 7, looks at the entry point for taxpayers. Now, remember, we have always had in the individual income tax a standard deduction and personal exemptions which define a zero bracket amount for individuals, and so what this picture then does in the same format is say, at what income level, using adjusted gross income as the measure, does the first tax bracket and the lowest tax rate apply? As you can see, the bubbles in this picture, through time, are fairly stable.

But of course, historically that is not the whole story, because the Congress, over the past 35 years, has enacted some significant provisions providing tax credits so that one could, at first calculation, be in any one tax bracket, or in particular in the lowest tax bracket, and then be eligible for a tax credit, reducing that tax liability—in fact, often reducing that tax liability to zero.

The prominent tax credits that have been enacted over the past 35 years are the Earned Income Tax Credit, the Child Tax Credit, and most recently, the Making Work Pay Credit. I note those three because they are all, in fact, refundable, so the simple picture that I have presented in Figure 2, of course, does not really represent what is happening in terms of taxes at the lower end of the income scale, but it does tell you the entry point and the marginal tax rates.

Now, more generally, the whole trend in the individual income tax system is not just about the tax brackets themselves and the marginal tax rates, but it keys very importantly on the definition of the tax base, an issue that Doug Elmendorf broached just a moment ago. We have had significant changes over the period in both directions, both broadening the base and narrowing the base.

As an example, in terms of broadening the income tax base, we have twice included partial inclusions of Social Security benefits. In 1975, there was no inclusion of Social Security benefits. Since that time, we have made two different inclusions of Social Security benefits, increasing the individual income tax base.

However, in the other direction, over this period we have had a growth in pension benefits and pension exclusions, so that many workers have seen lower taxable income because they receive from their employer pension benefits. We have also both increased and then scaled back the individual retirement arrangement provisions, which increase and then contract the individual tax base. And of course there have also been different limitations in terms of itemized deductions, which again help define the individual tax base.

Employment taxes, as noted by the chairman, are the second-most important component of the Federal tax system. Again, it is defined by the base, by tax rates. The FICA base, in real-dollar terms, since 1975, has nearly doubled. The HI base, the health base, which used to equal the FICA base, has been uncapped over the period, so has seen a substantial increase in terms of the dollars that are subject to tax under the payroll taxes. At the same time, over the past 35 years, the employee side of the tax rates has risen, from 5.85 percent in 1975, to the present day, 7.65 percent.

The next major component of the Federal tax system: corporate income tax. Again, I have presented just a bubble diagram. As you can see from the bubbles, the rate is generally down, but the level at which the rate applies——

The CHAIRMAN. What page is that?

Dr. BARTHOLD. Oh, I am sorry. That is page 22, Mr. Chairman.

The CHAIRMAN. Thank you.

Dr. BARTHOLD. I apologize.

The CHAIRMAN. Thank you.

Dr. BARTHOLD. But again, to really understand the changes over time, we would have to look at changes in the tax base. This would involve various changes in both directions in terms of treatment of cost recovery, accounting methods, and there is also the issue of the growth of the business income that is reported through flow-through entities, which the chairman mentioned in his opening statements.

That is my brief description. I am happy to answer any questions that the members might have in greater depth, and there is plenty of detail that the staff provided in JCX–51–10.

The CHAIRMAN. Yes. Thank you. There is a lot of detail.

[The prepared statement of Dr. Barthold appears in the appendix.]

The CHAIRMAN. All right.

Dr. Mazur, you are next. Thank you.

STATEMENT OF DR. MARK J. MAZUR, DEPUTY ASSISTANT SECRETARY, TAX ANALYSIS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Dr. MAZUR. Good morning. I would like to thank Chairman Baucus and Ranking Member Grassley for holding this hearing. I believe tax reform is an important topic. I am pleased to be part of a thorough consideration of all aspects of undertaking tax reform.

Today's topic is historical trends, which provides a backdrop for consideration of tax reform. My goal today is to discuss trends and patterns that have occurred over the last 3 decades or so to help frame how we should view the U.S. tax system as it exists today, and how perhaps it should be modified.

I want to start by making a few points about the overall economy, then I will turn my focus to the U.S. tax system and how it has shifted over time. I will try to make a few observations comparing the U.S. system to others around the world, and I will conclude with a few implications for possible future efforts on tax reform.

With respect to trends in the overall economy, I just want to make a half dozen points. First, the U.S. is, and has been, the world's dominating economy, responsible for about a quarter of the world's economic output, while having less than 5 percent of the world's population.

The second point is that the global economy has become more integrated in recent decades. The trade sector, if you take exports plus imports, has grown in the U.S. by about one-fifth over the last 3 decades, and is growing even more in some emerging countries like, say, India. In addition, cross-border investments, say in the form of corporate stocks held in other countries' companies, have increased 5-fold or more in the U.S. and in other G–7 countries.

The third point to make about the overall economy is that the pre-tax income distribution in the U.S. has shifted over the past 3 decades. The chairman talked a little bit about this. An increasing share of income is going to the most well-off. The top 1 percent of Americans doubled their share of total income from 1980 to 2007, and this concentration continues further up the income scale as you slice narrower and narrower.

The fourth point is that the last 3 decades have seen changing patterns of business entities. The chairman noted this as well. The traditional C corporation, subject to corporate income tax, made up about one-sixth of all entities and accounted for 87 percent of all receipts in 1980. By 2007, these fractions had changed to less than 6 percent of all entities and less than two-thirds of all receipts.

Since 1980, the U.S. Federal budget deficit has also changed quite a bit. You saw the CBO director's charts on this, that budget deficits persisted throughout the 1980s, were addressed in the late 1980s, early 1990s, leading to a budget surplus for a couple of years around the turn of the century, and now the Federal Government is facing large budget deficits which need to be addressed in the medium and long term.

The final point to make about the overall economy is the changing pattern of household living arrangements. Ranking Member Grassley referred to this a little bit, that there are larger numbers of single-parent families and multi-generational households than we had seen, say, in 1980 or before.

Now I would like to turn from the overall economy to changes experienced by the U.S. tax system. One key point is the shifting mix of revenues. Dr. Barthold pointed out there has been a shift in the share of individual income taxes. They now make up a smaller share of overall revenues, as do excise taxes, while social insurance taxes that fund Social Security and Medicare have increased over time.

A second point is the changing rate structure. For individual income tax rates, the top rate dropped from 70 percent in 1980 to 35 percent today. In the corporate area, the maximum statutory rate was 46 percent in 1980 and is 35 percent today. But that rate has not seen an across-the-board drop since the 1986 Tax Reform Act.

Over the last 30 years, the Alternative Minimum Tax has shifted from a separate tax system that affected a relatively small number of taxpayers to one that affects several million taxpayers, and generally not the most well-off taxpayers, nor the ones who make the greatest use of tax preferences. The rising size and number of tax expenditures has increased over time. In real dollars, this form of government support has more than doubled over the past 3 decades.

Fifth, the tax code has become ever more complex in the past 3 decades. There have been 30 major tax laws passed since 1980, and the changing laws, plus the use of sunsets and phase-outs, has made compliance difficult for taxpayers who rely on various features of the tax code, and made tax planning difficult as well.

Given this, it is no surprise that over half of taxpayers today rely on a paid preparer to do their tax return, and only about one-seventh do their returns the old-fashioned way with paper and pencil, perhaps sitting at the dining room table.

I would like to sum up with just some observations for possible tax reform. The U.S. faces this situation from a position of strength. We have a strong economy and tax policy choices can matter, and we know that, but they are not the dominant force in people's decisions. Tax policy choices matter more at the margin. As Senator Grassley said, they can have an effect, but the effects tend to be relatively small and, as I said, on the margin.

Second, Federal budget deficit concerns are likely to lead the call to raise additional revenue in the future. An idea of revenue-neutral tax reform, that is a big lift. That is hard to do. If you are raising revenue as well, it probably increases the challenge of that task.

The third point is, tax policy needs to balance a number of factors: efficiency, equity or fairness, and administrability, as well as burden on taxpayers. Simplifying the tax code, as simplicity matters here, makes it easier for taxpayers who want to comply to actually comply with the tax law and makes it easier for the Internal Revenue Service to administer the law. Taxing businesses is more challenging today than in the past with the rise of flow-through entities and an increasing reliance on intangible assets.

On the individual tax side, the tax policy must confront the Alternative Minimum Tax, which has really grown in size and scope. All these challenges can be dealt with, but it will take wisdom and the will to do so. I look forward to working with this committee on this important and needed effort. Thank you. I look forward to taking your questions.

The CHAIRMAN. Thank you, Doctor, very much.

[The prepared statement of Dr. Mazur appears in the appendix.]

The CHAIRMAN. I obviously have a lot of questions. Just focus a little on the trend, whether there is a reduction proportionately in C corporations in the guise of pass-throughs, and the question is why? Why has that happened? Has that happened because, say, back in 1986 C corporations had a lower tax rate compared with the individual rate, and so individuals would shelter some of their income in C corporations? That is not the case today, the rates have changed so much. Is that one possible reason?

Or is another possible reason for the rise of LLCs so that proprietors could reduce some of their liability without using the C corporation structure, and also avoid the so-called double taxation? But the real question is, why this big shift? It is very remarkable that there has been this shift, and I would like to ask each of the three of you if you could comment on the reasons why, and so what? Is that important or not important?

Dr. BARTHOLD. I will lead off, Mr. Chairman. Why? I do not think there is firm, empirical analysis that explains why. You have offered two of the leading candidates for reasons. As you noted, in the mid-1970s, the top tax rate on individuals on investment-type income was 70 percent, and the top C corporate rate was 46 percent.

So that gave incentives for people to perhaps leave income in a C corporation, even though it would be taxed at a 46-percent rate. It was better than having it come out and be taxed at a 70-percent rate. It could be deferred, and then it would be possible actually to liquidate the C corporation and ultimately get most of that income out tax-free.

Now the Congress, in response to that sort of, if you want to call it stuffing, or just holding of income within a C corporation, did enact personal holding company rules and some other anti-abuse rules. Now, of course, the 1986 Tax Reform Act lowered the top corporate rate to 34 percent, which is a significant reduction, and lowered individual rates at the same time, but it made it much less attractive to keep money within corporations. And also changes in terms of the General Utilities doctrine made it harder just to liquidate and get money out of a corporation.

So one reason is the rate play. Another reason is the legal structure that changed along with the tax law. You also noted that the rise, probably beginning in the late 1980s, early 1990s, of State law developments in terms of limited liability corporations, made it easier to have essentially the same kind of structure taxed as a pass-through entity for Federal purposes.

I think it is probably not just the case that State law changed, but also the ability of financiers and the financial markets to aggregate capital for investment outside of a New York Stock Exchange or a NASDAQ or the American Stock Exchange—in other words, without having to go public. It became significantly cheaper to raise funds for business entities, so the combination of sort of financial innovation, or let us just say the increased liquidity in the

U.S. financial system, combined with the ability to do limited liability partnerships, limited liability corporations, probably affected that.

The CHAIRMAN. My time is expiring.

Dr. BARTHOLD. I did not mean to filibuster you. I apologize.

The CHAIRMAN. No problem. No problem.

Dr. MAZUR. Just to add two points to that. One, I think that the State tax law changes actually were a big driver in this, and it became much more acceptable for entities to establish themselves in that form and maintain it, and they were able to attract the financing that Dr. Barthold talked about. In addition, there are the "check the box" rules that basically allow taxpayers to determine for themselves how they would like to be taxed, as a pass-through or as a corporation. That also has helped.

The CHAIRMAN. What about the basic question: does it matter? So what? Should we be concerned?

Dr. BARTHOLD. I will jump back in. I mean, the theoretical notion is, there have long been tax reformers who have said you should integrate completely business taxes with individual taxes and just treat it all as income to the owners and then apply whatever rates that the Congress thinks are appropriate, and that that would increase efficiency because it would remove double taxation, it would remove bias against a C form, so there could be a lot of benefits.

Now, in the opposite direction, of course, it is a significant change in terms of the tax base, so it would mean you would have to have different tax rates at the individual level, and there would be a lot of trade-offs involved. It is obviously not a bad thing, theoretically, to have people integrating business taxes into the individual tax system themselves.

The CHAIRMAN. Thanks very much.

Senator Grassley?

Senator GRASSLEY. Dr. Mazur, you are the only one here appointed by the President, so I ask you this question. I also ask it because, in my opening paragraph, I spoke about tax reform bringing in about the same amount of revenue we get now. Also, because the 50-year average of the Gross Domestic Product coming in through taxes has been about 18.2 percent.

Then I am going to quote a very short paragraph that was written during the last campaign, August 14, 2008, by Jason Furman and Austan Goolsbee, "The Obama Tax Plan." It says, "Overall, Senator Obama's middle-class tax cuts are larger than his partial rollbacks for families earning over $250,000, making the proposal as a whole a net tax cut and reducing revenues to less than 18.2 percent of GDP—the level of taxes that prevailed under President Reagan."

So a very simple question: do you think this is still the policy of the administration, to end up with about the same amount of taxes coming in, about 18.2 percent of GDP, a 50-year average?

Dr. MAZUR. I think the policy of the administration is to develop a revenue stream that supports the services that the Federal Government should deliver to taxpayers, so, whether that is a decision by Congress and the administration that the size of government should be 18 percent of GDP or some other number, is a different matter.

I think what Dr. Goolsbee and Jason Furman were talking about during the campaign was that they were not proposing a broad, across-the-board tax increase, but actually were trying to maintain some reasonable level of taxation. If you look at where revenues are now, they are around 15 percent of GDP. So I think you are actually looking at a significant gap between what we are raising as a government and what we are promising to pay, or what we are paying out in terms of expenditures. Reducing that gap is important to do.

Senator GRASSLEY. Yes. But you would expect that gap, would you not, to be reduced simply because the economy improves. We are still in a recession. When the economy improves, you would get it back up to 18.2. In fact, under existing tax law, if we did not change it at all, it looks like after 10 years we would be at about 19 percent.

Dr. MAZUR. Under current law, I think Dr. Elmendorf showed it was somewhere around 20 percent by fiscal year 2020.

Dr. ELMENDORF. Around 21 percent by fiscal year 2020 under current law, Senator Grassley.

Senator GRASSLEY. Right. Yes.

Dr. MAZUR. That is current law, with the 2001 and 2003 tax cuts expired, and so on.

Senator GRASSLEY. All right.

So then when I was saying 19 percent, that would be if we would extend existing tax policy where it has been the last 10 years, if we extended it.

Dr. ELMENDORF. In particular, our estimate is based on numbers from the staff at the Joint Committee on Taxation, that a permanent extension of the expiring 2001 and 2003 tax cuts, combined with indexing of the Alternative Minimum Tax, would put revenues at about 19 percent of GDP in 2020.

Senator GRASSLEY. All right.

I have a question for Dr. Barthold and Dr. Mazur. There is some evidence showing—and you alluded to this, Dr. Mazur, about my comment on it—that the top quintile of earners today earns a significantly larger share of the national income than would have been the case, pick a year, but I pick 1960.

In particular, I am interested in knowing how much this reflects marriage trends. The Finance Committee had a witness back in 2007 who pointed out that if two middle quintile income people marry each other but still remain at their pre-marital salaries, they would then, as a taxpaying unit, be in the top quintile as they now would be filing jointly.

Also, marriage rates have fallen, particularly in lower-income people. So share your thoughts about how to interpret the data regarding top quintile income earners earning a larger share of national income today with what it may have been decades ago, making sure that we are accounting for different marriage rates today versus 50 years ago.

Dr. MAZUR. I think generally the distribution tables that we have used, and you noted this, do not account for family size or type. However, you can adjust for family size, basically looking at per capita income, or as CBO does, looking at poverty level multiples of income, and you get about the same story, that the distribution of pre-tax income has changed over time, with more income going to higher-income households.

Dr. ELMENDORF. Senator Grassley, I can just add that the calculations that we do traditionally of the distribution of the tax burden look at households, so to that extent people who are living in one housing unit independent of their official marital status would be grouped as a household, and we adjust for household size to reflect the fact that there can be economies of scale in living together. But we do not actually have numbers ourselves that are broken down by types of filing units in the way that you have asked the question.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman.

I appreciate all three of you coming. I appreciate the work that you do. I have worked with Dr. Elmendorf and Dr. Barthold pretty extensively and have a lot of regard for both of you. Dr. Mazur, we think very highly of you as well.

My questions this morning are for all of our witnesses; whoever wants to answer first, or second, or third is fine with me. Dr. Mazur's testimony points out that, after 1986, our corporate tax rate was relatively low compared with that of other developed nations. Now, since then, however, other countries have cut their corporate tax rates, leaving ours near the highest in the world today—in fact, the highest, I think.

Dr. Mazur further points out that, in terms of revenue raised as a percentage of GDP, the U.S. corporate tax rate is about equal to the OECD average. Now, do you think global corporations looking around the world to invest are concerned whether a country's corporate tax brings in about the same in terms of GDP as other countries? Do you think they care more about the tax rate that they are going to pay?

Dr. MAZUR. I think actually it is a complex decision. When a company is deciding where to locate an investment, they look at taxes, but it is not just the maximum statutory tax rate. They look at the entire tax system, so the various preferences that are available for investment, various incentives to do activities like hiring, R&D, and so on. That is a tax component, but it is even a broader decision than that. They look at labor markets, and so on.

Senator HATCH. I agree with that. There are all kinds of considerations. But I am limiting my comments to the tax world. Let me just expand on that. Do you think that our high corporate tax rate, when combined with our international tax regime, which is now—or soon will be—the only major system that taxes businesses on their worldwide income, has anything to do with the fact that the U.S. is now home to only 16 of the top 50 corporations in the world, whereas in 1980 we had 39 of the top 50 corporations in the world? Do you think it has had anything to do with that?

Dr. MAZUR. I think the effect would be pretty marginal on that.

Senator HATCH. You actually think that? Then why are we so stupid that we are losing all these major corporations, if it is not the way we are treating them from a tax standpoint and otherwise?

Dr. MAZUR. I guess I would say it is not that we are losing these corporations, it is that the worldwide economy has become much more global than it was, say, in 1980. So larger companies are growing in various parts of the world, some in the U.S. and some elsewhere.

Senator HATCH. Do you two agree with that?

Dr. ELMENDORF. Senator, I would just say, from our perspective, we agree that it is the tax rate that corporations face that will affect their decisions, not the overall revenue collected. But as Mark says, it is not just the statutory rate, it is also all the features of the tax code.

Senator HATCH. I agree with that. But I hear from these corporations that the tax rate is very, very important to them. The deferral laws are very, very important to them. There are a whole raft of other things very important to them as far as the taxing system is concerned. I also know corporations that are leaving. I have talked to a number of the corporate leaders in this country who said, look, if these rates stay the same, we are going to leave. We just have to.

Of course, it is not just because of the corporate tax rate. There are a lot of factors in addition that have made it unpleasant to really do business in the United States of America. I predict that over time, businesses are going to flee California because of the high regulatory burdens, and so forth that they place on them. We are doing the same thing, to a degree, the way we have operated over the last number of years.

So I do not want to make it so simplistic, but do you believe that these higher corporate tax rates are part of the reason then—let me be a little more specific—why we are losing some of these businesses? I mean, it used to be that the United States was the preferred place to do business because we are the go-go Nation. Now it seems like we are starting to lose that status in this world.

Dr. ELMENDORF. So, I think, Senator, that corporate tax rates and the corporate tax system are a significant factor in business decisions.

Senator HATCH. I hear it all the time. In fact, that is the number-one thing they always tell me. Of course it is not the only thing that is causing them to leave. Our over-regulatory nature is causing this as well. The whole ungodly tax code is causing it. It is a lot more than just the rates themselves. But the rates themselves are what I am interested in in these questions.

Dr. Barthold, do you have any comments on this?

Dr. BARTHOLD. I do not know if I have anything significant to add compared to Mark or Doug. As you have, we are——

Senator HATCH. Would you continue——

Dr. BARTHOLD. What I was going to add is, there have certainly been cases that the Congress is aware of, and it has been quite clear, where companies have chosen to invert and become a foreign corporation. One of the rationales that they have given their shareholders is that they will be able to increase their after-tax cash flow to the shareholders by having a lot of their foreign operations not under the U.S. worldwide system. So, I believe that would be consistent with the points that you are making.

The one additional thought that I would add to that is, you had noted that the U.S. used to be viewed as the go-go place, as the place to do business. In the debate about foreign corporations or whether you are a domestic corporation, it does not obviously mean that you are not doing business in the United States. So in the inversion situation, it is, where do you claim that you are headquartered? Now, there are a lot of important issues in terms of having headquarters, because does headquarters bring skilled jobs with it that other sorts of operations do not?

But it is certainly the case that the U.S. is still a very vibrant and desired place for foreign business to be. Foreign auto manufacturers have located in the United States, substantial investments, substantial amounts of jobs. They do a substantial amount of their research. The question is, would more be done if these were U.S. businesses?

Senator HATCH. Thank you.

Mr. Chairman, I have to leave, but would it be possible for me to ask one more question?

The CHAIRMAN. Yes. Briefly.

Senator HATCH. It will be brief.

You mention that we need to solve this AMT problem that has jumped from 155 people to 23–26 million, by some counts. We need to solve the Research and Development Tax Credit. Both of them should be solved. That should be made permanent so that would also help keep businesses. I hope you agree with me on this, or at least tell me where you think you are.

I would get rid of those two problems by making R&D permanent and by getting rid of the AMT, even without offsets. Now, the SGR, the fix, we do have $500 billion that the Democrats have taken out of Medicare, and we have been told that $282 billion of that would fix that for the next 10 years, or permanently, really. I think that would be an offset that makes sense.

But would it not be good to do that and to do those things and get rid of this awful AMT that is eating us alive, where we have to patch it every year and it keeps going up every year and gets worse and worse and worse, and just face that problem? Then also give our businesses the certainty of having the R&D tax credit that Senator Baucus and I have worked our guts out on, and other members on this committee over the years, to try to keep our high-tech world the best in the world.

Dr. ELMENDORF. Senator, as you know, CBO does not recommend or endorse any particular policy.

Senator HATCH. I know.

Dr. ELMENDORF. But I agree, and I think most analysts would agree, that greater predictability on the part of households, businesses, physicians, about the nature of the tax rules and spending rules that they will face would be an important contributor to their ability to plan for the future.

Dr. MAZUR. Clearly, you are right. On the first two issues, you are right where the President is. The President proposed a permanent R&D credit. We are there.

Senator HATCH. Why do we not do it?

Dr. MAZUR. The President proposed to index the AMT exemption for inflation permanently. We are there. So on those two, I think that they would provide the kind of certainty that businesses and individuals need.

The CHAIRMAN. Thank you, Senator.

Senator HATCH. Thank you.

The CHAIRMAN. Just one comment. I cannot let it go by. We are not re-litigating health care reform, but you said Democrats took $500 billion out of Medicare. That is not——

Senator HATCH. Well, we did not do it, I will tell you that.

The CHAIRMAN. If I might continue.

Senator HATCH. Go ahead. But we did not do it.

The CHAIRMAN. If I might continue. That leaves the impression—incorrect, I might add—that beneficiaries are being cut. That is not the case.

Senator HATCH. Well, it sure as hell is! I mean, what do you think the Medicare Advantage program is doing?

The CHAIRMAN. Core benefits are not cut. I just do not want partisan shots in this committee.

Senator HATCH. There is a difference, I admit.

The CHAIRMAN. Other subjects are not before us right now.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Gentlemen, anybody with a television set knows that the Congress is now in the middle of a debate about whether to keep the Bush tax cuts for everybody or to have some alternative, perhaps for some fraction of the population.

My question, and I think perhaps for you, Dr. Mazur, and you, Dr. Elmendorf—you are welcome to chime in as well, Dr. Barthold—would either of the approaches that are being debated now not perpetuate what I believe certainly you, Dr. Mazur, and you, Dr. Elmendorf, have talked about, and that is a growing ominous trend towards the increasing cost of special interest tax expenditures that distort the incentives a free market economy needs to grow? Dr. Mazur?

Dr. MAZUR. Well, first, if you are talking about the 2001 and 2003 tax cut extension, that has nothing to do with the tax expenditures. So you are right, it is a separate issue. It does nothing to address the growing tax expenditures. As my colleagues pointed out, over time they have doubled in real terms over the last 3 decades, so they are separate issues and probably should be handled separately.

Senator WYDEN. All right.

Dr. Elmendorf, given the fact that this debate does not touch what the Fiscal Commission, you, and Dr. Mazur have talked about—I thought you made a very good point, where you said the fact that we have all these tax expenditures that reduce the income on which taxes are levied, means tax rates have to be higher because of tax expenditures. Does this not make the case for having tax reform move to the point where it is done sooner rather than put off for years and years, given the fact that you all have just outlined this ominous trend? Is that not an argument for going to tax reform sooner?

Dr. ELMENDORF. Again, Senator, we do not advocate policies——

Senator WYDEN. I am just talking about economics.

Dr. ELMENDORF [continuing]. But I think it is a widespread view among tax experts that the current U.S. tax code does not collect revenue in nearly the most efficient available way, and I think it is a widespread view among tax experts that, if tax expenditures were reigned in in some way, that would enable the government to collect the same revenue at lower tax rates, or collect more revenue at the given tax rates, and would in either case allow for revenue to be collected with less distortion of behavior, and thus in a more efficient way.

Senator WYDEN. Let us talk—and you touched on it in your testimony, Dr. Mazur—about the historical trend towards complexity. As far as I am concerned, this system is just insanely complicated. To have Americans spending close to 8 billion hours a year filling out these forms, nearly 10,000 sections of code, we go through $190 billion a year just trying to comply with the tax laws, and you, it seems to me, note, particularly in the last 30 years, that we are on the ascent to yet more complexity.

In other words, we had less after we did the 1986 tax reform. Then shortly after it was passed, we went back on a trend towards yet more complexity, more cost, more time, more market distortions. Is that not something policymakers again ought to be looking at and saying, we have to move quicker rather than just putting it off for years and years more?

Dr. MAZUR. Well, it is all a balancing act. I think the balancing act is, you want to get the appropriate amount of revenues in as effective and efficient a way as possible. You want to have a tax system that is fair. You want to have one that does not impose incredibly large administrative and other tax burdens on taxpayers. So you balance all those things out. And you are right to note that 1986 was probably the high point over the last, say, 50 years or so in terms of reforming the tax system and making it less complex. Since then, the trend has been toward more complexity.

Senator WYDEN. I thought your point towards the end of your written testimony on simplification has to be one of the historical trends people pay attention to. Year in, year out, this gets denser, it gets thicker. The instruction book, the number of regulations, the percentage of individuals filing their tax returns with paid preparers has gone up exponentially just in the last 15 years.

So whether it is tax expenditures, whether it is complexity on count after count, if you look at the relevant measures that we need for growth, for fairness, for what the economy needs, it argues for moving more quickly rather than just putting this off again for years and years while the special interests gather outside this room and try to persuade the Finance Committee to go further.

Again, Mr. Chairman, I want to to just close my questions by thanking you for making it clear that we are really going to dig into this. I mean, we have already had a number of hearings. You have your hands full. I just want you to know, I really appreciate the fact that you are committing us to looking at this.

The CHAIRMAN. Thank you, Senator.

Well, I think you can tell this is a very popular subject by the attendance here. [Laughter.]

I would like to ask just about income disparity in America. There are all kinds of statistics, but generally I think it is agreed that over the last, say, 20 years, approximately, that the pre-tax income and the after-tax income of the most wealthy has increased as a share, I guess, of, what?

Dr. ELMENDORF. Total income.

The CHAIRMAN. Total income. That is right. Thank you. Whereas, other income earners, that is not the case. So the basic question is: to what degree is that caused by the tax code? I am assuming that is not a good thing, that it is widening at such a rapid rate.

To what degree is that caused by the code, to what degree is that caused by other factors? Just being honest about it, often this gets to be a big, partisan political debate on the floor, and sometimes here. People use statistics to try to score political points. But I am trying to get away from all that. I am trying to figure out what is going on, what is causing this maldistribution of income. What are the basic causes, and does the tax code have anything to do with it?

Dr. ELMENDORF. I can start, if you would like. Actually, Mr. Chairman, if you turn to the last exhibit, the last page of the written testimony—I did not bring a big poster for this—Exhibit 18 on page 24 shows the shares of before-tax and after-tax income by income quintile in 1979 and 2007. The picture shows that, between 1979 and 2007, the share of before-tax income fell from each income group, except for the highest quintile.

The share of income received by the highest quintile rose from 46 percent to 56 percent over that period. We note, but do not show in the picture, that the share of before-tax income for the 1 percent of households with the highest income more than doubled, from 9 percent to 19 percent. And you also can see in the picture that after-tax income is distributed a little more evenly than before-tax income because the Federal tax code is progressive, but not a lot more evenly.

There is substantial literature on the sources of this change in income over time. We have done some work for this committee and are in the process of finishing two other studies for this committee, documenting the changes in the distribution of earnings and income over time, and reviewing the literature about the explanations.

I think the leading cause, in the assessment of most analysts, is increasing demand for workers with high skills, particularly high levels of education. Over the course of the entire last century, there has been an ongoing increase in demand for workers with more education, and, at different points over that period, the supply of workers with more education has also increased. Obviously we have many more people graduating from high school and many more from college than we had decades ago.

During periods in which the supply of those workers with higher skills has grown as rapidly, or more rapidly than the demand, then we have tended to see the wage differences narrow. In periods in which the supply has not grown as rapidly as demand, we have seen the wage differences widen. It is the basic story of supply and demand for different sorts of labor.

In fact, over the past few decades, the educational achievement of the U.S. population has not been increasing the way it had in the past. It has basically plateaued in terms of the share of people graduating from college. So, supply has not kept up. The supply of highly educated workers has not kept up with the demand for them. I think most people view that as the leading source of the widening of the earnings distribution and the overall income distribution.

Now, there are other factors as well. There is a vigorous debate about the role that increased international trade has played. I think most analysts think that has not been as important a factor, but it is hard to know for sure. There have been changes in the structure of the economy, so the financial sector is a sector which has grown rapidly and is a sector that has a wide dispersion of earnings levels.

That has been set back at least over the past few years, but what will happen going forward is less clear. So there are a lot of possibilities and probably a lot of things have played some role, but I think most people would agree that the biggest role has been played by just the increasing demand for workers with a lot of education and high technical skills, and our, as a society, not providing the extra supply to keep pace with that.

The CHAIRMAN. Dr. Barthold?

Dr. BARTHOLD. I do not know that I have anything really to add to Doug's point. The question on the role of the tax system would be to perhaps think about the effectiveness of some of the policies that the members have enacted to try to increase human capital formation, things that we have done for the education sector and for training. Since productivity depends upon capital, perhaps there is some role for how investment in the United States is affected by the tax system.

But in terms of the broad—I am not aware of really any evidence that has laid at the tax code's doorstep failure to see more educational achievement. U.S. investment has been fairly strong for the past several decades, so capital formation has been fairly strong, too. So that would probably not explain the trends that Doug described for you.

The CHAIRMAN. Dr. Mazur?

Dr. MAZUR. Just two other points to add to that. I think, one trend over the last, say, 50 or so years, there has been a decline in the role of unions, and that has kind of, I think, helped shift or change the shift of income a little bit, especially away from the middle quintiles. Then at the very tip-top of the income distribution, there has just been a rise in basically a winner-take-all mentality, that, if you look at pro athletes, entertainers, top financial sector participants, the returns that they get on an annual basis are just astronomical compared to what they were, say, 30 or 40 years ago. That may reflect an ability to exploit larger markets, worldwide markets, say, than they could in the past.

The CHAIRMAN. Thank you.

Senator Menendez, you are next, if you want to go next.

Senator MENENDEZ. I am happy to go, Mr. Chairman.

The CHAIRMAN. Good.

Senator MENENDEZ. Gentlemen, thank you for your testimony.

Dr. Elmendorf, let me ask you, your organizations have done a lot of good work in modeling which policies have the most direct effect on short-term job creation. Not surprisingly, your reports have shown both Unemployment Insurance and tax breaks for middle-class families and businesses who hire topping the list.

I found that, at the bottom of the list, the proposal that creates the least amount of jobs, according to that study, is extending the Bush tax cuts for the wealthiest. Why is that?

Dr. ELMENDORF. First, let us make sure we are clear on the results. As you said, Senator, on our list, which was ordered by the "bang for the buck," so not the total effect on economic activity, but the effect per dollar of budgetary cost, on the top of that list was increasing aid to the unemployed, and below that were several alternative ways of establishing a payroll tax holiday that would both encourage spending and encourage businesses to hire. At the other end of the list is the extension of the expiring 2001 and 2003 tax provisions.

The reason that falls low on the list is because we think that a temporary extension of those provisions of the sort that we studied would not induce a very large amount of extra spending per dollar of budgetary cost. Now, we have also done analysis of different ways of extending the expiring tax provisions. In testimony I gave to the Senate Budget Committee at the end of September, we looked at four different ways of extending the provisions that had been discussed.

One was a permanent extension of all the provisions, one was a permanent extension of all the provisions except those focused on higher-income taxpayers, one was a temporary extension of all the provisions, and the fourth was a temporary extension of all the provisions except those affecting the highest-income taxpayers.

All four of those alternatives would, in our judgment, increase spending in output and employment during the next few years, because they would basically put money into taxpayers' hands, and thus the taxpayers would spend some share of that and that would raise the demand for goods and services, and thus output and employment. We also said that, over a longer period, by 2020 and beyond, all four of those options by themselves would lower economic activity because of the effects of the crowding out of private capital due to the extra government debt that would offset the positive effects of the lower tax rate.

Senator MENENDEZ. So in your listing, they do not create the greatest bang for the buck, so to speak. They do create some, but they do not create the greatest bang for the buck.

Dr. ELMENDORF. That is exactly right.

Senator MENENDEZ. So, to the extent that we are looking at tax policy as a creator of short-term job growth, you would want to go for the greatest bang for the buck. To the extent that, while creating the tax cuts for the wealthiest in the country in the short term can be part of that at the bottom of your list, in the long term they have serious consequences if you seek permanent extension of them.

Dr. ELMENDORF. Yes, that is right, Senator.

Senator MENENDEZ. All right.

Dr. Mazur, I gleaned from your testimony that the experience of the last 30 years of cutting taxes for the wealthiest has not led to increased prosperity. The top tax rate has been cut in half over the last 30 years. During that same time period in which the top tax rate has been cut in half over the last 30 years, incomes from the majority of American families have stagnated. So I look at that as a tax policy that cuts for the wealthiest in the country and has not really ultimately dramatically increased the value of paychecks for middle-class families.

But I often hear from my colleagues on the other side that that is the way in which we are going to create prosperity for all. In fact, some of my colleagues suggest that nothing else should happen in what is left of this Congress until we do that. So do you believe that, based upon the historical record, that tax cuts for the wealthiest have a significant effect on wages and job creation? If your answer to that is yes, then how come that is not borne out by the last 30 years of experience?

Dr. MAZUR. First, the administration's budget proposal did have the tax cuts from 2001 and 2003 expiring for people with incomes over $250,000. So I think the administration's position is pretty clear, that the bang for the buck, or the benefit of doing that is less than the benefit of the revenue that would be raised by imposing those taxes.

I think, if you look at the history of tax rates over time, you would see how taxpayers react to rates is several-fold. The first thing taxpayers can do if rates change is change the timing of their benefits; so, if tax rates were going to go up next year, you would see bonuses accelerated from 2011 to 2010, if possible. You would also see taxpayers engage in paper transactions, to take income that is one form, highly taxed, and transform it to another form that is somewhat less taxed.

Kind of far down the list is where people change their real economic behavior in response to marginal changes in the tax rates. The tax rates for all of us have dropped over the last 5 years. I do not think any of us have really increased our work effort in a credible amount over the last 3 years.

Senator MENENDEZ. If I may, Mr. Chairman, just to follow up on this.

The CHAIRMAN. Fine. Go ahead.

Senator MENENDEZ. So we have gone from, 30 years ago the top rate was in the 70th percentile, and it is now in the 30 some-odd percentile. So, half over the last 30 years has not—what I am trying to see is the correlation that some suggest exists between the dramatic cut in the top tier and what that means for the rest. The rest have not ultimately achieved any significant result as it relates to that. Is that a fair statement?

Dr. MAZUR. I think you just cannot look at changing one tax rate and say changing that tax rate is going to drive the entire economy. It is much more complex than that. I think that is the takeaway from that.

Senator MENENDEZ. All right.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Wyden, you are next.

Senator WYDEN. Thank you, Mr. Chairman.

Dr. Barthold, let me continue this discussion about tax expenditures, and particularly the exponential growth. It now comes to $1.1 trillion, so in effect, when Americans fill out these tax forms, have that joyous day in April when they send it in, that money goes to Washington, DC, out the door it goes for tax breaks.

On the Finance Committee, when we hold a mark-up of a piece of legislation and a particular Senator has a proposal for a tax change, a tax break for what is almost always a good cause, you all do a cost analysis and you give that to the chairman and you give it to the ranking minority member, and we all get it.

I am curious as to whether you have information as a result of doing that cost analysis that would also tell us what benefit the American people would get out of it so that we could at least start bringing to this discussion the opportunity to have a broader debate about what it is the American people are actually getting for this trillion-plus dollars of tax breaks that they are paying for.

The reason I am asking you this is, this is something that could be very helpful to the debate about taxes, and possibly something that we could actually start bringing in to our debate. It would not be water torture for you, because my question is, do you have some of that information now because of what you have had to do to put together the costing analysis that you give us, as you always have traditionally?

Dr. BARTHOLD. That is a really tough question, Senator.

Senator WYDEN. The question is, how do you get to the cost question without knowing the benefits?

Dr. BARTHOLD. Well, the benefit, as you well know, in the policy design, the benefit is not always just about, I have reduced somebody's tax liability. If I can choose one—and this is not to say anything negative about the Congress's decisions—the section 45 production credit creates tax benefits for a number of alternative energy resources.

Now, there is one sense in which you can measure the benefit. You can say, ah, producer A's tax liability is lower by X amount of dollars because they have done this thing that is consistent with the tax expenditure that was created. But from talking to the members and their staff, I know that the benefit that the members actually want assessed is, well, how much, if it is a windmill, for example, fossil-fired electricity was displaced by the wind?

Well, we can make an assessment. I mean, our revenue estimates are based, in that situation, on assessments of the amount of electricity that will be generated by the windmill, in my hypothetical example. But that in itself does not define what the policymakers, what you and your colleagues, see as the benefit from perhaps displacing a different energy source. There are multiple different ways that people may assess that.

Now, one simple way is, we can look at the cost of—let us compare the wind to perhaps a coal-fired power plant. We could look at the cost of procuring the coal. But generally, I think the members have wanted to say, well, it is not just the cost of the coal. There might be pollution that comes out of a stack, and that can have some health harms. Well, maybe we could measure the health harms. We do not do that as part of a revenue estimate.

Another consequence is, people have been concerned about pollution in terms of global warming. Well, that is not a health harm, per se, but that is another cost. We just do not collect all that information.

Senator WYDEN. Right. I can see why, in areas like energy, and if you use one source you are displacing another, that to get at an extensive benefit analysis of what you get for the money, could be hard. I just at least think we could get some information, for example, about how many jobs would be created with some of these changes that we are asked to consider. I will not prolong this; my time is up. I just have come to the conclusion that, when we ask you to cost something out and you send us that piece of paper that says it will cost X, that calculation you have made has to be based on a number of activities you think are going to take place.

Mr. Chairman, I just would like to talk with you about this further, because I think it is an idea that at least would give us more information. In other words, it would not change the authority of the committee and the members as we go forward. It might just give us a little bit more context in that piece of paper, and I would like to talk with you some more about it further.

The CHAIRMAN. You bet. More information usually helps. Thank you.

I am a little bit curious on another issue. Let us talk a little bit about worldwide and territorial. There are some—in fact, many—members of Congress who currently believe that the U.S. worldwide system is an impediment to the growth of jobs in the U.S. They point out that, because of the deferral regime, that a lot of companies keep their earnings and their control of corporations, subcorporations, overseas. If they were brought back to the U.S., they would have to be brought back at the current rate.

So the argument is, those companies just keep their earnings overseas. That creates jobs overseas and reduces jobs in the U.S. Some of the thinking is, it is not directly related, but others suggest we go to a territorial system because our current system makes us less competitive, the argument goes, because we tax all our income worldwide. Under territorial, other countries just tax income earned in their own country and do not tax income earned in a foreign country.

I just am curious of your thoughts generally on all this talk about converting to territorial as opposed to worldwide, because I guess the U.K. has recently converted. Others point out to me that actually most of this is not black and white, that each system has its exceptions, and so on and so forth.

So I guess, two questions. One is general, which is: what do you think about the degree to which moving more toward territorial would help American competitiveness? That is one question. The other is more specific. That is, the degree to which it would help, or hurt on the margin, in creating jobs in the U.S. Who wants to start?

Dr. MAZUR. I will just start with, the administration's budget proposals were intended to strengthen the worldwide system, and so I think we believe that the worldwide system is workable and that it is not a major impediment to U.S. competitiveness.

Just to note, there are pluses and minuses to all these tax systems. A territorial system would put more pressure on transfer pricing, would put more pressure on dealing with the role of intangible assets. The current tax system puts some pressure on it, and

I do not think we deal with it particularly well. Putting more pressure on it does not seem like that is a great plan.

The CHAIRMAN. What do you mean, "put more pressure on transfer pricing"? Do you mean, put more pressure on——

Dr. MAZUR. Well, think about if you earned income abroad. Under a territorial system, if you are a U.S.-based multi-national and you earn income in Belgium, under a territorial system it is not taxed.

The CHAIRMAN. Right.

Dr. MAZUR. You would like to find a way to put more income in Belgium.

The CHAIRMAN. Correct.

And while you are answering, you can talk about the Dutch sandwich. [Laughter.]

Dr. MAZUR. Yes, you could. I think the other thing to keep in mind is just that a territorial system can be very tight and can potentially raise about as much revenue as the current system, or it could be quite loose. I think that, when you hear the business community talk about a territorial system, they are not looking at one that raises more revenue than the current system.

The CHAIRMAN. All right.

Dr. Barthold?

Dr. BARTHOLD. Well, I would fall in the camp that you described as "not black and white." Mark pointed out an important consideration for members. Under our present system, where we permit deferral of earnings that are actively reinvested, the simple mathematics of present value say that, if you keep it permanently offshore and reinvest it, then the effective U.S. tax rate on that income is zero. So that means that, on the investment abroad, the only income tax paid by the investor would be the foreign tax paid, which means, in that sort of limited case, it is a territorial system.

So our current system, with elements of deferral, has sort of elements of territoriality. Now, what a lot of issues then come down to in terms of design, I think, are a little bit of what Mark was broaching: well, how do we treat some of the allocation of costs within the system?

I mean, one thing that the Congress has wrestled with, and I know it was important to you, to your considerations over the past several years, was interest allocation. If the interest is—if we borrow in the U.S. to invest abroad, how do we allocate that interest expense? Do we allocate it all against a U.S. tax base; do we allocate some against the foreign tax base? That ends up affecting the net return to the investment abroad. So those are a couple of important considerations.

A couple of the broader considerations that you asked about really go to an issue on which there is a growing body of economic literature that is not all one-sided, and that is the extent to which foreign investment is a substitute for domestic investment or a complement of domestic investment. I think the key in thinking about that is a little bit the question that you are asking when you asked about the competitiveness of the U.S. economy.

A lot of times we will hear members' constituents come in, and they think of competitiveness as, I would like a higher after-tax return for myself. Well, that does not necessarily mean that the U.S.

economy is growing, and so a broader sense of competitiveness is, you might say, well, what is the ability of the U.S. economy to grow, of the U.S. capital base to deepen, of the U.S. labor force to have better tools or better education, so that we see growth for U.S. citizens and U.S. residents?

That is not necessarily the same as saying one or two particular U.S.-based enterprises can improve their position in their markets worldwide. So that is a little bit about the question of, when are things a substitute to foreign investment in the United States as opposed to a complement for investment? I hope that gives a sense of the grayness that I want to bring to you.

The CHAIRMAN. Doug?

Dr. ELMENDORF. I would just add, Mr. Chairman, that we are in the process of doing substantial analysis of alternative ways of addressing international taxation, and we hope to bring that to you and to others soon.

The CHAIRMAN. I am very interested. Yes.

Dr. ELMENDORF. We are working very hard on that.

In response to your second question about jobs——

The CHAIRMAN. Right.

Dr. ELMENDORF [continuing]. I would just highlight a point that Tom made. Location of investment may affect the number of jobs, but it also importantly affects the nature of those jobs, the quality of the jobs, the rewards that are provided to the workers in those jobs. I think you and other members, when you talk about jobs, sometimes it sounds like it is numbers. I know what you actually mean is that, what is important is not just the number of jobs, but also the nature of them. But analyzing the effects of a sweeping change in U.S. corporate tax structure on the things that you and others care about is very challenging.

The CHAIRMAN. Well, it is also very important because the world is changing so much. We just have to make sure we are not falling behind, or even treading water, and maybe we can get ahead of the game. It takes a lot of work to figure that out.

Senator Wyden?

Senator WYDEN. Only one other, Mr. Chairman, just to follow up on your point.

Dr. Mazur, I would be interested in a little more of the administration's thinking on this question the chairman has raised, the question of what kinds of policies are needed, as it relates to global competitiveness, and how we are going to take on China and India in these tough markets. Is the administration interested?

I mean, it seems to me, going to the point that was just made by Dr. Elmendorf, that if, for example, you made changes in deferral, which creates an incentive to do business overseas, and took those very same dollars and used those dollars to reduce rates in the United States, you could, for example, give a very strong boost to American manufacturing, which strikes me as going to the point that Dr. Elmendorf said to the chairman: it relates to the kind of jobs that you might have.

So to pick up on the chairman's question, what are the administration's current thoughts about tax policy as it relates to how we achieve that increased competitiveness in global markets, and particularly use those changes to create more good-paying jobs here in the United States?

Dr. MAZUR. I think, if you look at the administration's budget proposal for fiscal year 2011 and then subsequent announcements by the President, you would see a number of themes there. One, I think that on the international side, there were some proposals to strengthen the international tax system and actually raise some additional revenues from U.S.-based multi-nationals.

I think, second, you saw proposals to have a bonus depreciation regime in place for investments in the U.S., and equipment. The President then proposed to expand that to have expensing, 100 percent expensing for qualified investments, through the end of 2011. In addition, you see a proposal for a permanent R&D credit, and even an enhanced one, which again would focus attention on doing those high-value activities within the United States. So taken together, I think you have a framework for focusing attention on doing high-value activities within the United States. That is consistent with the President's goal of doubling U.S. exports.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Just following on that question a little bit, I will ask each of the three of you: what are the three major changes you can recommend in the tax code, individual or corporate, that will—well, let us keep it on the business side—enhance and create more jobs in the U.S., all things being equal, changes in tax policy?

Dr. ELMENDORF. Mr. Chairman, as you know, I do not do policy recommendations. And when one says, "all else being equal," it depends just on what else one is doing to make it equal. I mean, in terms of the corporate tax code——

The CHAIRMAN. Like that. What changes would make the most difference?

Dr. ELMENDORF. I am just still stuck on the whole "we do not make policy recommendations," Mr. Chairman.

The CHAIRMAN. I am unsticking you. [Laughter.]

Dr. ELMENDORF. Well, sorry, it is not that easy. We are pretty stuck on that, for 35 years and in statute. I think my lawyers would advise me not to go further.

I think one theme that has come out of the presentations that we have made today and some of these discussions is that the tax code that carves out pieces of a base and then tries to raise the same amount of revenue through higher tax rates is likely to be distorting the decisions of individuals or businesses in a way that makes the raising of that revenue less efficient than would be the case if the base were broader and tax rates were lower.

Now, raising money efficiently is not the only objective of tax policy. Provisions that are in there that narrow the base of the corporate or individual tax are there for reasons that you and your colleagues have been attracted to over the years.

So this is not a recommendation to take those things out, but I think many analysts would say that those provisions should be scrutinized carefully, because they may appear, individually, to be subsidies for activities that you would like to subsidize. They are equally penalties for other activities that are not subsidized through special provisions and end up facing higher tax rates in an effort to raise the amount of revenue that you choose to raise.

The CHAIRMAN. Dr. Barthold?

Dr. BARTHOLD. Well, as you know, Mr. Chairman, I also have to at least figuratively bob and weave. Lower tax rates are better than high tax rates. There is a budget constraint, so you cannot just lower tax rates. The members have to choose. I am not going to offer a recommendation, but what I will offer is what the Joint Committee staff always offers, which is our best effort to provide you with information so that you and the members can make assessments.

Now, one of the things that Senator Wyden pointed out, and a couple of the other members, and actually the co-panelists pointed out, is, if you would look at some of the different provisions that are labeled as tax expenditures, it may create inefficiencies because certain investments may get treated better than other investments. Members have had reasons for doing that, so you want to assess, as Senator Wyden was suggesting, what is the benefit for the costs. One of the costs might be the inefficiency.

Mr. Chairman, as you and I spoke about, I think it was a couple of months ago now, the House of Representatives, in a tax bill that they passed that the Senate has not had the opportunity to address yet, would, by statute, require our staff to review and provide the members with information on cost, benefits, efficacy of a number—in fact, a very large number, I might add—of the expiring tax provisions.

Our staff stands ready, to the limit of the number of hours that we have available, to provide that information to the members of the tax-writing committees so that you can make the assessments so that I think we can achieve what members on both sides of the aisle would like, which is a system that is as efficient as possible with the lowest rates possible.

The CHAIRMAN. Thank you.

Senator Wyden, any final points?

Senator WYDEN. No.

The CHAIRMAN. Thank you, all three, very much. This is just the beginning of a much greater, in-depth series of tax reform hearings. But thank you very, very much for helping to frame some of the basic questions. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:46 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PRESENT LAW AND HISTORICAL OVERVIEW OF THE FEDERAL TAX SYSTEM

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on December 2, 2010

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

December 1, 2010
JCX-51-10

CONTENTS

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on December 2, 2010, on "Tax Reform: Historical Trends in Income and Revenue." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a summary of the Federal tax system, briefly describes its historical development over the period of time beginning in 1975, and provides an appendix of selected historical data on Federal tax rates, Federal tax receipts, components of adjusted gross income, and other features of the Federal tax system.

The current Federal tax system has four main elements: (1) an income tax on individuals and corporations (which consist of both a "regular" income tax and an alternative minimum tax); (2) payroll taxes on wages (and corresponding taxes on self-employment income); (3) estate, gift, and generation-skipping transfer taxes, and (4) excise taxes on selected goods and services.

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Historical Overview of the Federal Tax System* (JCX-51-10), December 1, 2010. This document can be found on the website at www.jct.gov.

I. SUMMARY OF THE FEDERAL TAX SYSTEM

A. Individual Income Tax

In general

An income tax is imposed on individual citizens and residents of the United States.[2] The tax is based on an individual's taxable income. An individual computes his or her taxable income by reducing gross income by the sum of (i) the deductions allowable in computing adjusted gross income, (ii) the standard deduction (or itemized deductions, at the election of the taxpayer), and (iii) the deduction for personal exemptions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her income tax liability. Lower rates apply to net capital gain and qualified dividend income. A taxpayer may also be subject to an alternative minimum tax. A taxpayer may reduce his or her income tax liability by certain tax credits. In the remainder of this section of the document, the broad structure of the individual income tax system is outlined, and certain parameters of the individual tax system are highlighted for selected years beginning with 1975.

Gross income

Gross income means "income from whatever source derived" other than certain items specifically excluded from gross income. Sources of gross income generally include, among other things, compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,[3] and trusts or estates.[4] Exclusions from gross income include death benefits payable under a life insurance contract, interest on certain tax-exempt State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

[2] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

[3] In general, partnerships and S corporations are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of these entities is passed through and taxed to the partners and shareholders.

[4] In general, estates and trusts (other than grantor trusts) pay an individual income tax on the taxable income of the estate or trust. Items of income which are distributed or required to be distributed under governing law or under the terms of the governing instrument generally are included in the income of the beneficiary and not the estate or trust. Estates and trusts determine their tax liability using a special tax rate schedule and may be subject to the alternative minimum tax. Certain trusts are treated as being owned by grantors in whole or in part for tax purposes; in such cases, the grantors are taxed on the income of the trust.

Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include, among other things, trade or business expenses, losses from the sale or exchange of property, deductions attributable to rents and royalties, contributions to pensions and other retirement plans, certain moving expenses, and alimony payments.

Taxable income

In order to determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. Table 1, below, summarizes the amount of personal exemptions for selected years between 1975 and 2010. Beginning in 1985, the amount of the personal exemption was indexed annually for inflation during the preceding year. Appendix Figure 1 shows the real value of the personal exemption from 1950 to 2010 in 2010 dollars.

Table 1.–Personal Exemption and Standard Deduction, Selected Calendar Years 1975-2010

	1975	1985	1990	1995	2000	2005	2010
Personal Exemption	$750	$1,040	$2,050	$2,500	$2,800	$3,200	$3,650
Standard Deduction							
Single Individual	$1,600*	$2,390	$3,250	$3,900	$4,400	$5,000	$5,700
Head of Household	$1,600*	$2,390	$4,750	$5,750	$6,450	$7,300	$8,400
Married Couples Filing Jointly	$1,900*	$3,540	$5,450	$6,550	$7,350	$10,000	$11,400
Married Individual Filing Separately	$950*	$1,770	$2,725	$3,275	$3,675	$5,000	$5,700

* Shows minimum standard deduction.

A taxpayer may also reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. Prior to 1977, the standard deduction was the larger of a "percentage standard deduction" and a "low-income allowance" (minimum standard deduction). The percentage standard deduction was a specific percentage of AGI, with a limit of a maximum standard deduction dollar amount. In 1975 that percentage was 16 percent, the maximum standard deduction was $2,300 for unmarried persons and heads of households and $2,600 for married taxpayers filing joint returns, and the minimum standard deduction was $1,600 for single returns and $1,900 for married taxpayers filing jointly. In 1977, a fixed dollar amount for the standard deduction was adopted by the Tax Reduction and Simplification Act of 1977 through introduction of "zero-bracket amount" exemption deductions. Those fixed dollar amounts have subsequently changed over time. Table 1, above, also shows the amount of standard deductions for the selected years. Also, an additional standard deduction is allowed with respect to any individual who is elderly or blind.[5]

In lieu of taking the applicable standard deduction, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales)[6], real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI). Generally, the total amount of most itemized deductions allowed is reduced for taxpayers with incomes over a certain threshold amount, which is indexed annually for inflation. Appendix Table 1 shows the number and percent of returns claiming the standard deduction versus itemizing deduction from 1950 to 2008. Appendix Figure 2 shows the real value of the standard deduction for single filers and married filers filing jointly from 1970 to 2010, and the percentage taking the standard deduction.

In recent decades there have been many changes to the individual income tax base. The increased availability of Individual Retirement Arrangements[7] (commonly called ("IRAs")) followed by the subsequent curtailment of their availability[8] and the taxation of a portion of Social Security and Railroad Retirement Tier 1 benefits[9] are two items which affect the measurement of gross income for some taxpayers. The enactment of "pre-tax benefits" designed to respond to increased health-care costs are examples of changes to adjusted gross income.[10] The calculation of taxable income has been affected by the numerous changes to itemized deductions. Examples of such changes include the creation of the two-percent floor on miscellaneous itemized deductions,[11] changes to the tax treatment of moving expenses,[12] and

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[5] For 2010, the additional amount is $1,100 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,400. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2010) of $2,200 or $2,800, as applicable.

[6] Itemized deductions for State and local income taxes expire at the end of 2010.

[7] The Economic Recovery Tax Act of 1981 (Pub. L. No. 97-34).

[8] The Tax Reform Act of 1986 (Pub. L. No. 99-514).

[9] The Social Security Amendments of 1983 (Pub. L. No. 98-21), as amended by the Railroad Retirement Solvency Act of 1983 (Pub. L. No. 98-76) and the Consolidated Budget Reconciliation Act of 1985 (Pub. L. No. 99-272). The Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66).

[10] The Revenue Act of 1978 (Pub. L. No. 95-600).

[11] The Tax Reform Act of 1986 (Pub. L. No. 99-514).

[12] The Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66).

changes to the floor on the itemized deduction for medical expenses.[13] Another significant change to the individual income tax base was the enactment of a limitation on passive losses which affects tax liability on certain business investments by individuals.[14]

Tax liability

In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax.

Regular tax liability

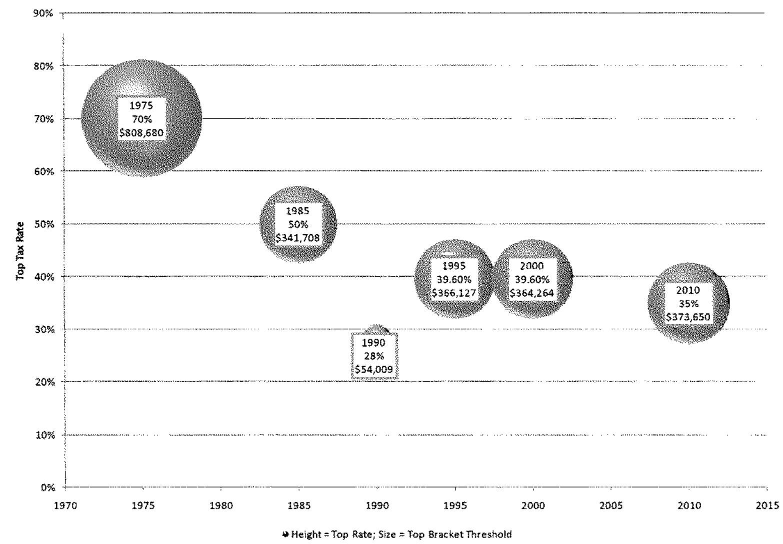
To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. The regular individual income tax rate schedules for 1975, 1985, 1990, 1995, 2000, and the present year 2010 are shown in Appendix Tables 2 through 7.

Figure 1 below, shows the top tax bracket rate and income level at which it begins to apply for married tax payers filing jointly for selected years. Figure 2 shows the bottom rate and the income level at which it would begin to apply for married taxpayers filing jointly, calculated as the sum of the standard deduction and two personal exemptions. Appendix Figure 3 shows the full rate structure for selected years in real 2010 dollars.

[13] The Internal Revenue Act of 1954 (Pub. L. No. 83-59) set the floor at 3%, the 1982 Tax and Equity Fiscal Responsibility Act (Pub. L. No. 97-248) raised the floor to 5%, the Tax Reform Act of 1986 (Pub. L. No. 99-514) raised the floor to 7.5%, and the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) raised the floor to 10%.

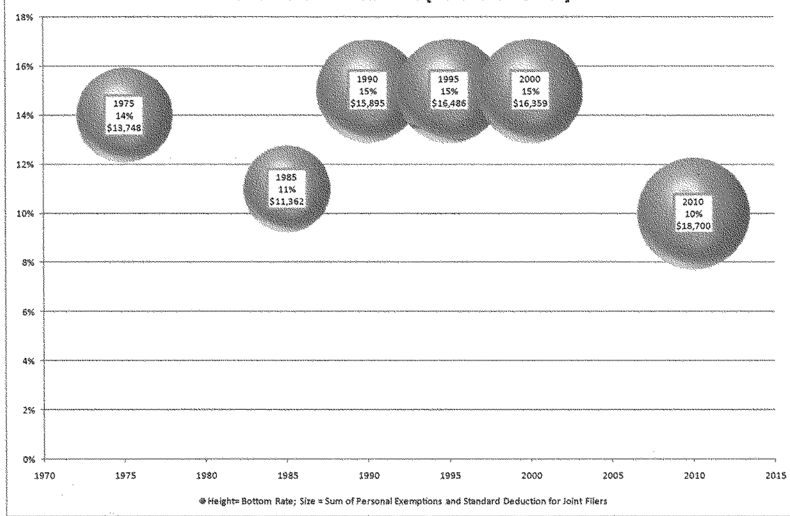
[14] A more complete discussion of the passive loss rules is included in the corporate income tax section of this pamphlet.

Figure 1.—Individual Income Tax Top Brackets and Rates, Joint Filers Selected Years [Real 2010 Dollars]



Special rules have long applied to capital gain income to limit the amount of gain included in income or to reduce the rate of tax imposed on gain. Appendix Table 8 summarizes the tax regime for long-term capital gain from 1913 to 2010.

Figure 2.–Individual Income Tax Bottom Rates and Bracket Thresholds, Joint Filers Selected Years [Real 2010 Dollars]



Tax credits

In general.–The individual may reduce his or her tax liability by any available tax credits. Tax credits are allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain dependent children and child care expenditures, and for certain elderly or disabled individuals. In addition, a refundable earned income tax credit ("EITC") is available to low-income workers who satisfy certain requirements.

A brief description of the most widely used credits follows.

Earned income tax credit.–The EITC, enacted in 1975, generally equals a specified percentage of wages up to a maximum credit amount. The maximum credit amount applies over a certain income range and then diminishes to zero over a certain income range. The income ranges and credit percentages have been revised several times since enactment, expanding the credit. As originally enacted in 1975, the credit was 10 percent of the first $4,000 of earned income[15] (i.e., a maximum credit of $400). The credit began to be phased out for filing units

[15] Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings.

with earned income (or AGI, if greater) above $4,000, and was entirely phased out for filing units with income of $8,000.

The Revenue Act of 1978 increased the maximum EITC to $500 and the income level at which the phaseout began was raised to $6,000. The Deficit Reduction Act of 1984 increased the maximum EITC to $550 (11 percent of the first $5,000 of earned income) and the credit was phased out beginning at $6,500 of income and ending at $11,000. Similarly in 1985, the credit was 14 percent of the first $5,000 of earned income and the maximum EITC was $550, while the credit began to be phased out for filing units with earned income above $6,500 and was entirely phased out for filing units with income of $11,000.

The Tax Reform Act of 1986 increased the maximum EITC to $800 (14 percent of the first $5,714 of earned income), beginning in 1987. The maximum credit was reduced by 10 cents for each dollar of earned income (or AGI, if greater) in excess of $9,000 ($6,500 in 1987). These $5,714 and $9,000 amounts (stated above in 1985 dollars) were indexed for inflation.

In 1990 and again in 1993, Congress enacted substantial expansions of the EITC. The Omnibus Budget Reconciliation Act of 1990 substantially increased the maximum amount of the credit. In 1990, the credit rate was 14 percent of the first $6,810 of earned income and the maximum EITC was $953. The credit was phased out beginning at $10,730 in income and ending at $20,264. The Omnibus Budget Reconciliation Act of 1993 expanded the credit in several ways. For individuals with one qualifying child, the credit was increased to 26.3 percent of the first $7,750 of earned income in 1994. For 1995 and thereafter, the credit rate was increased to 34 percent. Therefore in 1995, the credit was 34 percent of the first $6,160 of the earned income (this is a $6,000 base in 1994, adjusted for inflation), and the phaseout rate was 15.98 percent. The maximum credit for individuals with one qualifying child in 1995 was $2,094. For individuals with two or more qualifying children, the credit was increased to 36 percent of the first $8,640 of earned income in 1995. The maximum credit for individuals with two or more qualifying children in 1995 was $3,110 and was reduced by 20.22 percent of earned income (or AGI, if greater) in excess of $11,290. As for individuals with no children, the maximum credit was $314.

As seen above, the amount of the EITC varies depending upon the taxpayer's earned income and whether the taxpayer has one, more than one, or no qualifying children. In 2000, the maximum EITC was $3,888 for taxpayers with more than two qualifying children, $2,353 for taxpayers with one qualifying child, and $353 for taxpayers with no qualifying children. For 2000, the phase-out range was $5,770 to $10,380 for no qualifying children, $12,690 to $27,415 for one qualifying child, and $12,690 to $31,152 for two or more qualifying children.

In 2010, the maximum EITC is $5,666 for taxpayers with more than two qualifying children, $5,036 for taxpayers with two qualifying children, $3,050 for taxpayers with one qualifying child, and $457 for taxpayers with no qualifying children. Also, the EITC is phased out along certain phase-out ranges. In 2010, the phase-out range is $7,480 to $13,460 for no qualifying children, $16,450 to $35,535 for one qualifying child, $16,450 to $40,363 for two qualifying children, and $16,450 to $43,352 for three or more qualifying children. Also for 2010, the phase-out threshold for married couples filing a joint return is increased by $5,010.

Appendix Table 9 shows the number of recipients of the EITC and the average amount of the credit from 1975 to 2008.

Child tax credit.–Before 1997, taxpayers could not claim tax credits based solely on the number of dependent children. Instead, they were generally able to claim a personal exemption for each of these dependents. The Taxpayer Relief Act of 1997 provided for a $500 ($400 for taxable year 1998) tax credit for each qualifying child under the age of 17 while retaining the personal exemption rules. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendant of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer. For taxpayers with modified AGI in excess of certain thresholds, the child credit is phased out. The phase out rate is $50 for each $1,000 of modified AGI[16] (or a fraction thereof) in excess of the threshold. For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These thresholds are not indexed for inflation.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased the child credit on a phased in basis, reaching $1,000 in 2011, and provided for limited refundability of the credit.[17] EGTRRA made the child tax credit refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,000 for calendar years 2001-2004. The percentage was scheduled to increase to 15 percent for calendar years 2005 and thereafter. The $10,000 amount was indexed for inflation beginning in 2002. Families with three of more children were allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,000. EGTRRA also provided that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal Funds.

The Job Creation and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") increased the amount of the child tax credit from $600 to $1,000 for 2003 and 2004.[18]

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2011, is allowed against the AMT. To the extent the child tax credit exceeds the

[16] For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Marina Islands; and residents of Puerto Rico, respectively).

[17] The credit reverts to $500, and all of the other EGTRRA child tax credit rules expire, for taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

[18] The Working Families Tax Relief Act of 2004 increased the child tax credit to $1,000 for 2005-2009 and accelerated to 2004 the refundability of the credit to 15 percent of earned income in excess of $10,750, with indexing.

taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). EGTRRA provided, in general, that this threshold dollar amount is $10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 set the threshold at $3,000 for both 2009 and 2010. Accordingly, for 2010, the child tax credit generally is $1,000 but is phased-out for individuals with income over certain thresholds. For 2010, the child tax credit is refundable up to the greater of: (1) 15 percent of the taxpayer's earned income in excess of $3,000; or (2) for families with three or more children, the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income.

Making work pay tax credit.–The making work pay credit is a temporary refundable income tax credit available to eligible individuals for two years (taxable years beginning in 2009 and 2010).

The credit is the lesser of: (1) 6.2 percent of an individual's earned income; or (2) $400 ($800 in the case of a joint return). For purposes of calculating an eligible individual's credit, the definition of earned income is the same as for the earned income tax credit with two modifications. First, earned income does not include net earnings from self-employment which are not taken into account in computing taxable income. Second, earned income includes combat pay excluded from gross income under section 112.

The credit is phased out at a rate of two percent of the eligible individual's modified adjusted gross income above $75,000 ($150,000 in the case of a joint return). For purposes of the phase-out, an eligible individual's modified adjusted gross income is the eligible individual's adjusted gross income increased by any amount excluded from gross income under sections 911, 931, or 933. An eligible individual is any individual other than: (1) a nonresident alien; (2) an individual with respect to whom another individual may claim a dependency deduction for a taxable year beginning in a calendar year in which the eligible individual's taxable year begins; and (3) an estate or trust.

Alternative minimum tax liability

In general

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are also used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's "tax preference items" and adjusted by redetermining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2010 are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of unmarried individuals other than surviving spouses; (3) $22,500 in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust.[19] The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds: (1) $150,000 in the case of married individuals filing a joint return and surviving spouses; (2) $112,500 in the case of other unmarried individuals; and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions items, are not allowed to reduce alternative minimum taxable income.

Legislative history

The Tax Equity and Fiscal Responsibility Act of 1982 enacted the first comprehensive individual AMT.[20] Under the 1982 Act, in computing AMTI, the deduction for State and local taxes, the deduction for personal exemptions, the standard deduction, and the deduction for interest on home equity loans were not allowed. Incentive stock option gain was included in AMTI. These remain the principal preferences and adjustments under present law.

The Tax Reform Act of 1986 largely retained the structure of the prior-law AMT, since 1986, several changes have been made to the computation of the individual AMT. The principal changes are set forth below:

Adjustments and preferences.–The principal changes made in the determination of AMTI were to repeal the preference for charitable contributions of appreciated property; repeal the preference for percentage depletion on oil and gas wells; substantially reduce the amount of the preference for intangible drilling expenses; and repeal the requirement that alternative depreciation lives be used in computing the deduction for ACRS depreciation.

Rates.–The Omnibus Budget Reconciliation Act of 1990 increased the individual AMT tax rate from 21 percent to 24 and the rate was further increased by the Omnibus Budget

[19] The exemption amounts for 2009 were: (1) $70,950 in the case of married individuals filing a joint return and surviving spouses; (2) $46,700 in the case of unmarried individuals other than surviving spouses; (3) $35,475 in the case of married individuals filing separate returns; and (4) $35,475 in the case of an estate or trust.

[20] An add-on minimum tax was first enacted by the Tax Reform Act of 1969. The add-on minimum tax was repealed by the 1982 Act. The add-on minimum tax, as originally enacted, generally was a tax at a 10-percent rate on the sum of the specified tax preferences in excess of the sum of $30,000 plus the taxpayer's regular tax.

Reconciliation Act of 1993 to the 26- and 28-percent rate structure of present law (when the maximum regular tax rate was increased from 31 percent to 39.6 percent).

Exemption amounts.–The Omnibus Budget Reconciliation Act of 1993 increased the AMT exemption amounts to $45,000 ($33,750 for unmarried taxpayers). The AMT exemption amounts were temporarily increased to $49,000 ($35,750 for unmarried individuals) for 2001 and 2002, to $58,000 ($40,250 for unmarried individuals) for 2003, 2004, and 2005, to $62,550 ($42,500 for unmarried individuals) for 2006, $66,250 ($44,350 for unmarried individuals) in 2007, $69,950 ($46,200 for unmarried individuals) in 2008, and to $70,950 ($46,700 for unmarried individuals) in 2009.

Credits.–For 1998 and subsequent years, the nonrefundable personal credits have been allowed on a temporary basis to offset the AMT. The last extension, through 2009, was enacted by the American Recovery and Reinvestment Act of 2009.

B. Employment Taxes

Social security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages. The Federal Insurance Contributions Act ("FICA") imposes a tax on employers based on the amount of wages paid to an employee during the year. The tax as imposed in 1975 was composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 5.85 percent of covered wages up to the taxable wage base of $14,100; and (2) the Medicare hospital insurance ("HI") tax amount equal to 0.9 percent of covered wages. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee tax generally must be withheld and remitted to the Federal government by the employer.[21] Self-employed taxpayers are subject to payroll tax under the Self-Employed Contributions Act ("SECA"). The SECA tax in 1975 was imposed on the same wage base and was composed of the same OASDI and HI components, but the rate was equal to 7.9 percent (7 percent OASDI, 0.9 percent HI).

The earnings base is indexed each year automatically according to a statutory formula. Any increase in the earnings base is based on the increase in average wages in the economy.[22]

FICA payroll taxes were modified by the Social Security Amendments of 1983 (the "1983 Act").[23] Under this Act, coverage was extended on a compulsory basis to Federal employees,[24] members of Congress, the President and Vice-President, Federal judges, and employees of non-profit organizations. Up to half of the OASDI benefits were made includable in taxable income for taxpayers with incomes above certain base amounts. The 1983 Act also accelerated a previously-enacted increase in the tax rate and raised the retirement age, to begin in 2000.

The 1983 Act also raised SECA payroll taxes considerably. Prior to the 1983 Act, SECA taxes had been deliberately set lower than FICA taxes. The 1983 Act sought to erase this discrepancy starting in 1984 and achieving parity between SECA and FICA by 1990. Therefore, effective in 1990, only 92.35 percent of covered wages are taxable as "net earnings from self-

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[21] The OASDI and HI payroll tax is generally collected as a single tax with portions of it allocated by statute among three separate trust funds (OASI, DI and HI).

[22] The earnings base can only increase in a year in which there was an increase in benefits under the cost-of-living adjustment (COLA) formula. If there was no increase in benefits, the earnings base is prohibited from increasing. Sec. 230(a) of the Social Security Act. Since there was no increase in benefits from 2009 through 2011, the earnings base remained constant from 2009 through 2011 too.

[23] Pub. L. No. 98-2. High unemployment rates throughout the 70s as well as a decrease in real wages led to fears that the system would be vastly underfunded and a need to generate revenue quickly. The National Commission on Social Security Reform was created to address the issue, and its final report formed the basis for many of the 1983 amendments.

[24] If hired after December 31, 1983.

employment"[25] and the self-employed taxpayer receives a deduction for 50 percent of SECA taxes paid.[26]

The Omnibus Budget Reconciliation Act of 1989 modified the formula under which the annual increase in the earnings base is calculated. The modification included in the formula certain types of deferred compensation, such as contributions to a 401(k) plan.

As a result of the Omnibus Budget Reconciliation Act of 1990[27] the HI base was raised to $125,000 in 1992 and $135,000 in 1993.

As part of the Omnibus Budget Reconciliation Act of 1993,[28] the earnings base for the HI portion of the tax was removed, making all earnings taxable for HI purposes, effective in 1994. The maximum portion of social security benefits includable in taxable income was raised from up to half, to up to 85 percent, and the ceilings on the relevant income thresholds were increased.

Table 2 below, shows the evolution of the taxable wage base and rates of tax since 1975.

[25] This adjustment is made to reflect the fact that employees do not pay FICA taxes on the employer's portion of the FICA tax. Thus, the base is reduced by 7.65 percent, the employer's share of FICA taxes.

[26] This deduction mirrors the treatment for employees, who do not pay income tax on the employer's portion of the FICA tax.

[27] Pub. L. No. 101-518.

[28] Pub. L. No. 103-66.

Table 2.–Social Insurance Taxable Wage Base and Rates of Tax

Year	Annual Maximum Taxable Earnings	Contribution Rate for Employers and Employees (Percent of Covered Earnings)				Contribution Rate for Self-Employed Persons		
		Total	OASI	DI	HI	Total	OASDI	HI
1975	$14,100	5.85	4.375	0.575	0.9	7.9	7.0	0.9
1976	$15,300	5.85	4.375	0.575	0.9	7.9	7.0	0.9
1977	$16,500	5.85	4.375	0.575	0.9	7.9	7.0	0.9
1978	$17,700	6.05	4.275	0.775	1.00	8.1	7.1	1.0
1979	$22,900	6.13	4.33	0.75	1.05	8.1	7.05	1.05
1980	$25,900	6.13	4.52	0.56	1.05	8.1	7.05	1.05
1981	$29,700	6.65	4.70	0.65	1.3	9.3	8.0	1.3
1982	$32,400	6.7	4.575	0.825	1.3	9.35	8.05	1.3
1983	$35,700	6.7	4.775	0.625	1.3	9.35	8.05	1.3
1984[1]	$37,800	7.0	5.2	0.5	1.3	14.00	11.4	2.6
1985	$39,600	7.05	5.2	0.5	1.35	14.10	11.4	2.7
1986	$42,000	7.15	5.2	0.5	1.45	14.30	11.4	2.9
1987	$43,800	7.15	5.2	0.5	1.45	14.30	11.4	2.9
1988	$45,000	7.51	5.53	0.53	1.45	15.02	12.12	2.9
1989	$48,000	7.51	5.53	0.53	1.45	15.02	12.12	2.9
1990	$51,300	7.65	5.6	0.6	1.45	15.3	12.4	2.9
1991	$53,400	7.65	5.6	0.6	1.45	15.3	12.4	2.9
1992	$55,500	7.65	5.6	0.6	1.45	15.3	12.4	2.9
1993	$57,600	7.65	5.6	0.6	1.45	15.3	12.4	2.9
1994	$60,600	7.65	5.26	0.94	1.45	15.3	12.4	2.9
1995	$61,200	7.65	5.26	0.94	1.45	15.3	12.4	2.9
1996	$62,700	7.65	5.26	0.94	1.45	15.3	12.4	2.9
1997	$65,400	7.65	5.35	0.85	1.45	15.3	12.4	2.9
1998	$68,400	7.65	5.35	0.85	1.45	15.3	12.4	2.9
1999	$72,600	7.65	5.35	0.85	1.45	15.3	12.4	2.9
2000	$76,200	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2001	$80,400	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2002	$84,900	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2003	$87,900	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2004	$87,900	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2005	$90,000	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2006	$94,200	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2007	$97,500	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2008	$102,000	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2009	$106,800	7.65	5.3	0.9	1.45	15.3	12.4	2.9
2010	$106,800	7.65	5.3	0.9	1.45	15.3	12.4	2.9

[1] For 1984 only, employees were allowed a credit of .3 percent of taxable wages against their FICA tax liability, reducing the effective rate to 6.7 percent.

C. Corporate Income Tax

Since its inception in 1909, the Federal income tax assessed on the earnings of corporations as entities separate and apart from their owners has undergone significant changes, both with respect to the corporate income tax rate structure and the tax base. The following will describe the corporate income tax in general as it exists today, a history of the corporate income tax rates since 1975, and certain significant changes to the corporate income tax base since 1975.

In general

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income.[29]

The taxable income of a corporation generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenses, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year typically may be carried back two years or carried forward 20 years and allowed as a deduction in another taxable year. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied). Moreover, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.

The Code also specifies certain expenditures that typically may not be deducted, such as expenses associated with earning tax-exempt income,[30] certain entertainment expenditures,

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[29] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States.

A qualified small business corporation may elect, under subchapter S of the Code, not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation will flow through to the shareholders and be taxable directly to the shareholders. Special rules (not discussed herein) also apply to a corporation that has elected to be taxable as a regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).

certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, and fines, penalties, bribes, kickbacks and illegal payments.

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. Thus, the maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

Corporations are taxed at lower rates on income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. For taxable years beginning in 2008 and 2009, the deduction is equal to six percent of the income from manufacturing, construction, and certain other activities specified in the Code. Beginning in 2010, the percentage is increased to nine percent.[31]

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include, but are not limited to, credits for producing fuels from nonconventional sources, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the alcohol fuels credit (applicable to production of certain alcohol fuels), the research credit (applicable to qualified research expenses incurred prior to December 31, 2009), the low-income housing credit (applicable to investment in certain low-income housing projects), the enhanced oil recovery credit (applicable to the recovery of certain difficult-to-extract oil reserves), the empowerment zone employment credit (applicable to wages paid to certain residents of or employees in empowerment zones), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals). Credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. For purposes of calculating tax liability, corporations filing a consolidated return generally are treated as

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[30] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

[31] At the fully phased-in nine percent deduction, a corporation is taxed at a rate of 35 percent on only 91 percent of qualifying income, resulting in an effective tax rate on qualifying income of 31.85 percent (0.91 x 0.35 = 0.3185). A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

divisions of a single corporation; thus, the losses (and credits) of one corporation generally can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Alternative minimum tax

A corporation is subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[32] Credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, net operating losses and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceeds its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings and profits, and such a distribution is not a deductible expense of the corporation.[33] Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder.[34]

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[32] The exemption amount is phased out for corporations with income above certain thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

[33] A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of common stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

[34] This double taxation is mitigated by a reduced maximum tax rate of 15 percent generally applicable to dividend income of individuals (prior to 2011). Note that amounts paid as interest to the debtholders of a

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

Accumulated earnings and personal holding company taxes

Taxes at the top rate generally applicable to dividend income of individuals (currently 15 percent, and scheduled to increase to 39.6 percent in 2011) may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed on the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax are designed to ensure that both a corporate tax and a shareholder tax are effectively imposed on corporate earnings.

Tax treatment of foreign activities of U.S. corporations[35]

The United States employs a worldwide tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[36] and the passive foreign investment company rules.[37] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[38]

corporation generally are subject to only one level of tax (at the recipient level) because the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

[35] For more information regarding the tax treatment of the foreign activities of U.S. corporations, please see Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S Businesses* (JCX-22-06), June 21, 2006.

[36] Secs. 951-964.

[37] Secs. 1291-1298.

[38] Secs. 901, 902, 960, 1291(g).

Corporate income tax rates since 1975

A corporation's regular income tax liability generally is determined by applying the appropriate tax rate to its taxable income. Table 3 below, provides a compilation of the marginal rates of tax imposed on corporate income from 1975 to 2010.

Table 3.–Federal Corporate Income Tax Rate Structure Since 1975[39]

Year	Corporate Taxable Income	Income Tax Rate (percent)
1975-78	First $25,000	20
	Next $25,000	22
	Over $50,000	48
1979-81	First $25,000	17
	$25,001-$50,000	20
	$50,001-$75,000	30
	$75,001-$100,000	40
	Over $100,000	46
1982	First $25,000	16
	$25,001-$50,000	19
	$50,001-$75,000	30
	$75,001-$100,000	40
	Over $100,000	46
1983	First $25,000	15
	$25,001-$50,000	18
	$50,001-$75,000	30
	$75,001-$100,000	40
	Over $100,000	46
1984-1986	First $25,000	15
	$25,001-$50,000	18
	$50,001-$75,000	30
	$75,001-$100,000	40
	$100,001-$1,000,000	46
	$1,000,001-$1,405,000	51*
	Over $1,405,000	46

[39] Internal Revenue Service. Corporation Income Tax Brackets and Rates, 1909-2002.

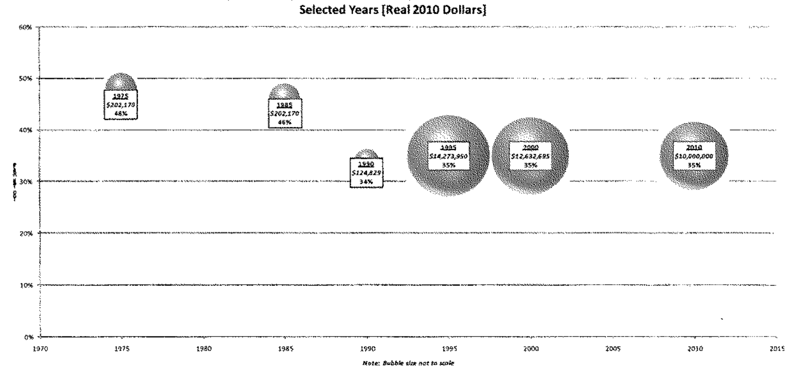
Year	Corporate Taxable Income	Income Tax Rate (percent)
1987[40]	First $25,000	15
	$25,001-$50,000	16.5
	$50,001-$75,000	27.5
	$75,001-$100,000	37
	$100,001-$335,000	42.5*
	$335,001-$1,000,000	40
	$1,000,001-$1,405,000	42.5*
	Over $1,405,000	40
1988-1992	First $50,000	15
	$50,001-$75,000	25
	$75,001-$100,000	34
	$100,001-$335,000	39*
	Over $335,000	34
1993-2010	First $50,000	15
	$50,001-$75,000	25
	$75,001-$100,000	34
	$100,001-$335,000	39*
	$335,001-$10,000,000	34
	$10,000,001-$15,000,000	35
	$15,000,001-$18,333,333	38*
	Over $18,333,333	35

* Rates higher than the top bracket rate reflect phaseouts of the benefit from the lower bracket rates and are not technically the top corporate statutory rate.

[40] The Tax Reform Act of 1986 established a new rate structure effective for tax year 1988 and made the rates for transition year 1987 an average of the pre-1986 Tax Reform Act rates for 1986 and the post-1986 Tax Reform Act rates for 1988.

Figure 4, below, shows the top statutory corporate income tax rate and income threshold at which the rate begins to apply for selected years.

Figure 4.- Corporate Income Tax Top Rate and Bracket Threshold
Selected Years [Real 2010 Dollars]



Significant modifications to the corporate income tax base since 1975[41]

The following discussion summarizes certain significant modifications to the corporate income tax base since 1975. In addition to affecting corporations, many of the Federal income tax provisions discussed below apply to all businesses.

Investment Tax Credit.–The Tax Rate Extension Act of 1962 created the investment tax credit.[42] The investment tax credit was originally seven percent (three percent in the case of certain public utilities) of investments in new tangible personal property and certain depreciable

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[41] For additional discussion of U.S. Federal income tax provisions affecting businesses, see generally Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2008* (JCX-32-08), April 14, 2008; Joint Committee on Taxation, *Overview of Past Tax Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals*, (JCX-4-08), January 21, 2008; Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2007* (JCX-2-07), January 12, 2007; Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Tax Issues* (JCX-41-06), September 19, 2006; Joint Committee on Taxation, *Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series* (JCX-23-02), April 4, 2002; Joint Committee on Taxation, Overview of Present Law and Selected Proposals Regarding the Federal Income Taxation of Small Business and Agriculture (JCX-45-02), May 31, 2002; Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001; Joint Committee on Taxation, *Overview of Present Law and Selected Proposals Regarding the Federal Income Taxation of Small Business and Agriculture* (JCX-19-01), March 27, 2001. See also Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* (1994); Joseph A. Pechman, *Federal Tax Policy* (5th ed.1987).

[42] Pub. L. No. 87-508, sec. 2 (1962).

real property (except buildings and structural components of buildings). No credit was allowed for property with a useful life of less than four years. For property with a life of four or five years, one-third of the investment was taken into account; for property with useful lives of six to eight years, two-thirds was taken into account; and for property with longer lives, the full amount of the investment was taken into account. Up to $50,000 of used property was eligible for the credit. The credit could offset tax liability in full up to $25,000, but above that amount, the credit could not reduce the tax liability by more than 25 percent. Any unused credit could be carried forward for five years and used in those years to the extent there was sufficient tax liability under the applicable limitation. If the property was sold before the end of its useful life, any excess credit was subject to recapture. The investment tax credit was suspended during the years 1966 and from 1969-1971. It was revived in 1972 and then increased to a rate of ten percent in 1975.

The Tax Reform Act of 1976 extended the 10 percent rate for the investment tax credit and continued the $100,000 limitation on qualified investment in used property from 1977 through 1980.[43] The Economic Recovery Tax Act of 1981 expanded eligible property to include petroleum storage facilities and certain rolling stock.[44] The used property limitation was increased to $125,000 for 1981 through 1984, and to $150,000 after 1984. A recapture provision was also added whereby the regular credit was recomputed upon early disposition by allowing a two-percent credit for each year the property was held (no recapture after five years, three years for eligible property). Additionally, the unused investment credits carry forward period increased from seven to 15 years, subject to certain limitations.

The Tax Reform Act of 1986 repealed the investment tax credit in an effort to equate effective tax rates with statutory tax rates and to rationalize the tax treatment of different assets.

Personal Service Corporations.–The Omnibus Budget Reconciliation Act of 1987 provided that, beginning in 1988, certain incorporated professional practices ("personal service corporations") are not eligible for graduated corporate rates but are taxed on all taxable income at the highest corporate income tax rate.[45]

Repeal of the *General Utilities* Doctrine.–In the Tax Reform Act of 1986, several corporate income tax provisions were modified to broaden the corporate income tax base and reduce the rates. Chief among these reforms was the repeal of the *General Utilities* doctrine. The Tax Reform Act of 1986 repealed a long-standing rule allowing an exception from the taxation of corporate earnings for unrealized or "built-in" gains held in corporate solution at the time of a liquidation of the corporation. This exception is generally viewed as originating in *General Utilities & Operating Company v. Helvering*,[46] and was later codified. The Tax Reform

[43] Pub. L. No. 94-555, secs. 801-2 (1976).

[44] Pub. L. No. 97-34, secs. 211 and 213 (1981).

[45] Pub. L. No. 100-203, sec. 10224 (1987).

[46] 196 U.S. 200 (1935).

Act of 1986 repealed the *General Utilities* doctrine, thereby generally requiring that a corporate-level tax be imposed on the built-in gains of a corporation upon its liquidation.[47] In the Omnibus Budget Reconciliation Act of 1987,[48] Congress clarified that the requirement of corporate-level taxation in cases of liquidations also extends to corporate dispositions utilizing subsidiaries—so-called mirror subsidiary transactions.

Taxation of Master Limited Partnerships ("MLPs").–An MLP is an investor-owned, publicly traded limited partnership that conducts business in a manner similar to a corporation. Prior to the Omnibus Budget Reconciliation Act of 1987, MLPs were taxable as partnerships and thereby exempt from corporate-level taxation. The 1987 Act required MLPs with active trade or business income (i.e., MLPs that do not derive most of their income from certain generally passive sources) to be treated as corporations for Federal tax purposes.

Corporate loss limitation following certain changes in stock ownership.–The Tax Reform Act of 1986 generally limited the amount of a corporation's pre-change losses that can be used annually following an ownership change to the tax-exempt rate multiplied by the value of the corporation at the time of the ownership change.[49] Prior law had imposed limits on corporate loss use following specified changes in ownership; generally with different results for stock purchases than for certain reorganizations.[50]

Depreciation.–Prior to 1981, the depreciation system was based on estimated useful lives determined either by using facts and circumstances or by using guideline lives in Treasury guidance.[51] The useful lives were generally applied to calculate depreciation deductions using a straight-line method. The Economic Recovery Tax Act of 1981 replaced the prior law depreciation system with the Accelerated Cost Recovery System ("ACRS") which significantly accelerated depreciation on tangible property.[52] ACRS is a system for recovering capital costs using accelerated methods over predetermined recovery periods that are generally unrelated to, but shorter than, prior law useful lives. For tangible personal property, the cost of eligible property was recovered over a 3, 5, 10, or 15-year period, depending on the type of property. The method used to calculate the depreciation expense was generally 150-percent declining balance (changing to straight-line) for property placed in service in 1981 through 1984, 175-percent declining balance (changing to straight line) for property placed in service in 1985, and 200-percent declining balance (changing to straight line) for property placed in service after

[47] The transactions subject to corporate level tax include the purchase of one corporation by another with an election to treat the transaction as an asset sale in which the buyer obtains a fair market value asset basis.

[48] Pub. L. No. 100-203, sec. 10223 (1987).

[49] Sec. 382 as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514 (1986).

[50] See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, (JCS 10-87), pp. 288-294.

[51] See Rev. Proc. 62-21, 1962-2 C.B. 418, for guideline useful lives.

[52] Pub. L. No. 97-34, sec. 201 (1981).

1985. A half-year convention applied under which a taxpayer claimed a half-year of depreciation in the year tangible personal property was placed in service and no depreciation in the year in which such property was disposed. Under ACRS, the cost of real property was recovered over 15 years on either an accelerated or straight-line method and a mid-month convention. The Tax Equity and Fiscal Responsibility Act of 1982 ended the phase-in of faster depreciation methods and reduced the basis for depreciation by one-half the investment tax credit.[53]

The Tax Reform Act of 1986 created a new modified accelerated recovery system ("MACRS") that included six classes of tangible personal property (3, 5, 7, 10, 15 and 20 years), where the 3, 5, 7, and 10-year property classes are depreciated using 200 percent declining balance and the 15 and 20-year classes are depreciated using the 150 percent declining balance method. Real property is depreciated using the straight-line method, with residential rental property recovered over a 27.5 year period and nonresidential real property recovered over a 31.5-year period. In 1993, Congress increased the recovery period for nonresidential real property to 39 years.

The Job Creation and Worker Assistance Act of 2002[54] provided an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[55] The additional first-year depreciation deduction was allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property was placed in service. The basis of the property and the depreciation allowances in the placed-in-service year and later years were appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there were no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies.

The Jobs and Growth Tax Relief Reconciliation Act of 2003[56] provided an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property.[57] Qualified property was defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction, except that the applicable time period for acquisition or self construction of the property and placed in service date requirement were modified. Property for which the 50-percent additional first-year depreciation deduction was claimed was not eligible for the 30-percent additional first-year depreciation deduction. This provision also extended the placed in service date requirement for certain property with a recovery period of 10 years or

[53] Pub. L. No. 97-248 (1982).

[54] Pub. L. No. 107-147, sec. 101 (2002).

[55] A taxpayer was permitted to elect out of the 30-percent additional first-year depreciation deduction for any class of property for any taxable year.

[56] Pub. L. No. 108-27, sec. 201 (2003).

[57] A taxpayer was permitted to elect out of the 50-percent additional first-year depreciation deduction for any class of property for any taxable year.

longer and certain transportation property to property placed in service prior to January 1, 2006 (instead of January 1, 2005). Congress extended bonus depreciation in 2008, 2009 and 2010.[58]

Section 179 Expensing.–In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. The rules of section 179 were originally enacted in 1958.[59] The 1958 legislation provided that a taxpayer could elect to deduct, as additional first-year depreciation, 20 percent of the cost of certain depreciable property. The cost of property eligible for this treatment was limited to $10,000, and consequently, the deduction was limited to $2,000 for the taxable year. Section 179 property was defined as depreciable property with a useful life of six years or more that was acquired by purchase after 1957 for use in a trade or business or for holding for the production of income.

In 1981, when the ACRS depreciation rules were adopted (generally providing accelerated methods and shorter recovery periods for depreciation), the section 179 rules were also revised to provide expensing of a greater amount of capital purchases.[60] The 1981 legislation provided that, for taxable years beginning in 1982 and 1983, a taxpayer could elect to deduct up to $5,000 of the cost of qualifying property placed in service in the taxable year. The dollar limitation was increased to $7,500 for taxable years beginning in 1984 and 1985, and increased to $10,000 for taxable years beginning in 1986 and thereafter.[61] Qualifying property was defined as property acquired by purchase for use in a trade or business (not including property held merely for the production of income). The provision was subsequently modified to provide that the dollar limitation on the deductible amount is reduced (but not below zero) by the amount by which the cost of section 179 property placed in service during the taxable year exceeds a dollar threshold (currently $400,000).[62]

The dollar limitation was further increased in 1993 to $17,500 for taxable years beginning after 1992.[63] In 1996, the expensing provisions were amended to provide for the

[58] The Economic Stimulus Act of 2008, Pub. L. No. 110-185 (2008), permitted taxpayers to take an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property generally placed in service in 2008 (2009 for certain longer-lived or transportation property). The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009), extended the additional first-year depreciation deduction for property placed in service in 2009 (2010 for certain longer-lived and transportation property). The Small Business Job Act of 2010, Pub. L. No. 111-240 (2010), extended the additional first year depreciation deduction for property placed in service in 2010 (2011 for certain longer-lived and transportation property).

[59] Pub. L. No. 85-866. sec. 204 (1958).

[60] Pub. L. No. 97-34, sec. 202 (1981).

[61] Subsequent legislation altered the years for which these amounts took effect. The $10,000 amount was to become effective for taxable years beginning in 1990 and thereafter, under section 13 of the Tax Reform Act of 1984, Pub. L. No. 98-369 (1984), but was made effective for taxable years beginning after 1986, under section 202 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (1986).

[62] See sec. 202 of Pub. L. No. 99-514 (1986).

[63] Pub. L. No. 103-66, sec. 13116(a) (1993).

dollar limitation to increase over a period of several years, ultimately reaching $25,000 for taxable years beginning in 2003 or thereafter.[64] In 2003, the $25,000 limitation was increased to $100,000, and the phase-out level of $200,000 was increased to $400,000 for tax years beginning in 2002 through 2006.[65]

Prior to the enactment of the Small Business Jobs Act of 2010[66] and the Hiring Incentives to Restore Employment Act of 2010 (the "HIRE Act"),[67] section 179(b)(1) prescribed a $125,000 limitation on the aggregate cost of section 179 property that could be treated as an expense for taxable years beginning after 2006 and before 2011. For those same taxable years, section 179(b)(2) provided that the $125,000 amount is reduced by the amount by which the cost of section 179 property placed in service during the taxable years exceeds $500,000. Both the $125,000 amount and the $500,000 amount were adjusted for inflation annually under section 179(b)(5). The Economic Stimulus Act of 2008[68] changed the $125,000 amount and the $500,000 amount to $250,000 and $800,000, respectively, for taxable years beginning in 2008. The American Recovery and Reinvestment Tax Act of 2009[69] extended the $250,000 amount and the $800,000 amount to taxable years beginning in 2009. The HIRE Act changed the $125,000 amount and the $500,000 amount to $250,000 and $800,000, respectively, for taxable years beginning in 2010. Subsequently, the Small Business Jobs Act extended and increased the $250,000 amount and the $800,000 amount to $500,000 and $2,000,000, respectively, for taxable years beginning in 2010 and 2011.

Amortization of goodwill and certain other intangible assets.–The Omnibus Budget Reconciliation Act of 1993[70] specified a 15-year amortization period for acquired goodwill and certain other intangible assets. Under prior law, goodwill was not amortizable and the amortization of other intangible assets was generally based on facts and circumstances.

Net Operating Losses.–Prior to 1981, the Code generally allowed corporations incurring net operating losses ("NOLs") in one taxable year to carry back the loss as a deduction to the three prior taxable years and to carry forward the loss for seven years. In 1981, the NOL carry forward period was extended to 15 years for NOLs in taxable years ending after December 31, 1975.[71] The Taxpayer Relief Act of 1997 amended the Code to allow corporations to carry back

[64] Pub. L. No. 104-188, sec. 1111(a) (1996).

[65] Pub. L. No. 108-27, sec. 202 (2003).

[66] Pub. L. No. 111-240 (2010).

[67] Pub. L. No. 111-147 (2010).

[68] Pub. L. No. 110-185 (2008).

[69] Pub. L. No. 111-5 (2009).

[70] Pub. L. No. 103-66 (1993).

[71] Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, sec. 207 (1981). NOLs of financial institutions were not modified; a carryback of 10 years and carryforward of five years was retained.

NOLs for two years and to carry NOLs forward for 20 years.[72] In 2002, the net operating loss carry back period was temporarily increased to five years for NOLs arising in taxable years ending in 2001 and 2002.[73] In addition, NOL carry backs arising in taxable years ending in 2001 and 2002, as well as NOL carry forwards to those taxable years, were allowed to offset 100 percent of a taxpayer's alternative minimum taxable income.[74]

The American Recovery and Reinvestment Act of 2009 provided eligible small business with an election to increase the carryback period for an applicable 2008 NOL from two years to any whole number of years elected by the taxpayer that is more than two and fewer than six.[75] An eligible small business is a taxpayer meeting a $15,000,000 gross receipts test. An applicable NOL is the taxpayer's NOL for any taxable year ending in 2008, or if elected by the taxpayer, the NOL for any taxable year beginning in 2008. The Worker, Homeownership, and Business Assistance Act of 2009 generally expanded the five-year NOL carryback election to any applicable NOLs arising in a taxable year beginning or ending in either 2008 or 2009.[76]

Add-on Minimum Tax.–From 1969 through 1986, corporations were subject to an "add-on minimum tax" on certain "tax preference" items (such as percentage depletion, accelerated depreciation, etc.) above a certain amount. For tax years 1969 through 1976, the tax was 10 percent of tax preferences in excess of $30,000; after 1976, the tax was 15 percent of preferences in excess of the greater of $10,000 or regular income tax.

Alternative Minimum Tax.–The alternative minimum tax ("AMT") replaced the add-on minimum tax, effective in 1987. It required a calculation of an alternative measure of taxable income that reduced or eliminated many tax preference items. The tax was 20 percent of the excess of this "alternative minimum taxable income" ("AMTI") over $40,000.[77] The $40,000 exemption was reduced by 25 percent of the excess of AMTI over $150,000. AMT in excess of regular tax could be carried over as a credit against regular tax in future years. Credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. The Taxpayer Relief Act of 1997 repealed the AMT for small corporations (generally those with average gross receipts of less than $5 million).

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[72] Pub. L. No. 105-34, sec. 1082 (1997).

[73] Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, sec. 102 (2002).

[74] Absent this special rule, NOL carryovers are only permitted to offset 90 percent of a taxpayer's alternative minimum taxable income. Sec. 56(d)(1)(A).

[75] Pub. L. No. 111-5 (2009).

[76] Pub. L. No. 111-92 (2009).

[77] The exemption amount is phased out for corporations with income above certain thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

High Yield Debt with Original Issue Discount.–In the Omnibus Budget Reconciliation Act of 1989,[78] Congress modified the tax treatment of instruments paying a rate of interest in excess of prevailing commercial rates that do not pay such interest on a current basis, such as certain original issue discount bonds. Under the 1989 Act, excessive yield rates in such cases are not deductible by the issuer. The nondeductible portion is treated as a dividend for purposes of the corporate dividends-received deduction.

Earnings Stripping.–An earnings stripping transaction is generally the payment of "excessive" deductible interest by a U.S. corporation to a related person when such interest is tax exempt (or partially tax exempt) in the hands of the related person. The Omnibus Budget Reconciliation Act of 1989 curbed the ability of foreign investors and other tax-exempt entities to use earning stripping transactions to obtain a competitive advantage over domestic corporate taxpayers.

[78] Pub. L. No. 101-239 (1989).

D. Estate and Gift Tax

The United States generally imposes a gift tax on transfers of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. An estate tax generally is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death and on certain property held by a nonresident alien if the property is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death.[79] The taxable estate generally equals the worldwide gross estate less certain allowable deductions.

In 1975 the estate and gift tax systems were two separate systems. The gift tax laws provided for an annual exclusion of $3,000 per donee, plus a lifetime exemption of $30,000. Gift tax was computed using a graduated rate structure, with a maximum gift tax rate of 57.75 percent applicable to cumulative lifetime taxable transfers over $10 million. Property transferred by gift generally received a carry-over basis.

The estate tax exemption in 1975 was $60,000. Estate tax was computed using a graduated rate structure with a maximum taxable rate of 77 percent; this top rate applied to taxable transfers at death of over $10 million. A marital deduction permitted the estate of the deceased spouse to deduct 50 percent of the value of property transferred to the surviving spouse. This generally had the effect of allowing both spouses to be taxed on one-half of the property's value, which generally resulted in similar treatment in community property states and non-community property states.[80] Property transferred at death received a "stepped-up" basis, or a basis generally equal to the fair market value at the time of death.

Although there have been many changes to the estate and gift tax laws over the years since 1975, there were three significant acts that substantially modified the estate and gift tax regimes. The Tax Reform Act of 1976 (the "1976 Act"), The Economic Recovery Act of 1981 (the "1981 Act"), and Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") are discussed briefly below.

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[79] In addition to interests in property owned by the decedent at the time of death, the Federal estate tax also generally is imposed on (1) proceeds of life insurance that was either payable to the decedent's estate or in which the decedent had an incident of ownership at death, (2) property over which the decedent had a general power of appointment at death, (3) annuities purchased by the decedent or his employer that were payable to the decedent before death, (4) property held by the decedent as a joint tenants, (5) property transferred by the decedent before death in which the decedent retained a life estate or over which the decedent had the power to designate who could possess or enjoy the property, (6) property revocably transferred by the decedent before death, and (7) certain transfers taking effect at the death of the decedent.

[80] Revenue Act of 1948, 62 Stat. 110.

The estate and gift tax system was substantially modified by the 1976 Act.[81] A single graduated rate table was created for both cumulative inter vivos gifts and taxable transfers at death, with the value of the taxable estate stacked on top of cumulative lifetime gifts to determine the marginal rate applied to the estate at death. In 1977, the top marginal rate was 70 percent; this top rate applied to cumulative inter vivos transfers and bequests of more than $5 million. The gift tax and estate tax exemption amounts also were combined into a single "unified credit" which was phased-in over time. In 1977 the unified credit effectively exempted $120,667 of inter vivos transfers and/or bequests from tax, and when fully phased-in in 1980 effectively exempted $161,563. The gift tax annual exclusion remained at $3,000.

The 1976 Act changed the basis rules such that property acquired from a decedent generally received a carry-over basis, rather than a step-up in basis to fair market value. The carry-over basis rules were retroactively repealed in 1980.

Another significant change in the 1976 Act was the introduction of an additional transfer tax on generation-skipping transfers. The generation-skipping transfer tax was designed to impose an additional tax on transfers which split enjoyment and ownership of property between two generations; generally where a beneficiary in the child's generation was given the right to use and benefit from property during life and a beneficiary in the grandchild's generation was given complete ownership of the property at the termination of the first interest.[82] The tax imposed was generally equal to the rates which would have applied if the property had been transferred outright by the donor and again by the first beneficiary.[83]

The Act also provided for a 100-percent marital deduction for the first $250,000 of property transferred to a surviving spouse.[84]

The Economic Recovery Act of 1981 (the "1981 Act")[85] made a number of additional changes to the estate and gift tax rules, many of which either had the effect of reducing the number of taxable estates or reducing or eliminating taxes on transfers between spouses. For example, the1981 Act increased the unified credit such that, when fully phased in by 1987, the unified credit effectively exempted the first $600,000 of transfers from the unified estate and gift

[81] Pub. L. No. 94-455 (Oct. 4, 1976).

[82] Without the generation-skipping transfer tax, such a bequest had resulted in estate or gift taxation of the property to the donor and the second beneficiary, but not the intervening, first beneficiary. The generation-skipping transfer tax added a complex series of rules which generally treated the termination of the first beneficiary's interest as a taxable event.

[83] The generation-skipping transfer tax was substantially altered in the Tax Reform Act of 1986 by applying a single rate of tax equal to the highest marginal estate tax rate (55 percent at the time) to all generation-skipping transfers over $1 million. The Act also broadened the definition of generation-skipping transfer to include "direct skips" (e.g. direct transfers from a grandparent to a grandchild).

[84] The 1976 Act included other changes beyond the scope of this document.

[85] Pub. L. No. 97-35 (Aug. 13, 1981). The 1981 Act included other changes beyond the scope of this document.

tax, and gradually reduced the top marginal estate and gift tax rate from 70 percent to 50 percent over a four-year period (1982 through 1985).[86] The 1981 Act increased the annual gift tax exemption from $3,000 per donee to $10,000 per donee. Furthermore, the 1981 Act generally provided for unlimited deductions for gifts and bequests to spouses.[87]

The Taxpayer Relief Act of 1997[88] provided for gradual increase in the unified credit effective exemption amount from $625,000 in 1998 to $1 million in 2006 and thereafter.

EGTRRA gradually reduced and temporarily repealed the Federal estate and generation-skipping taxes. EGTRRA reduced the estate and generation-skipping taxes through 2009 by gradually increasing the estate tax exemption to $3.5 million and reducing the top estate tax rate to 45 percent. During that time, the gift tax exemption for lifetime transfers remained at $1 million; a common graduated rate table continued to apply for gift and estate tax purposes. In 2010, the estate and generation-skipping taxes are repealed, though only for one year. Modified carry-over basis rules apply to assets acquired from a decedent who dies in 2010. During 2010, the gift tax exemption remains at $1 million and taxable gifts are subject to a 35-percent rate.

The estate, gift, and generation-skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions (including repeal of the estate and generation-skipping transfer taxes) do not apply to estates of decedents dying, gifts made, or generation-skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation-skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted apply for estates of decedents dying, gifts made, or generation-skipping transfers made in 2011 and later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of $1 million applies for purposes of determining the tax on cumulative taxable transfers made by a taxpayer through lifetime gift or bequest.

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[86] Subsequent legislation delayed the decrease in tax rates. The maximum estate and gift tax rates dropped to 50 percent after December 31, 1992, but the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (August 10, 1993) restored the 55- percent top rate retroactively to January 1, 1993, and made that top rate permanent.

[87] Pub. L. No. 97-35 (Aug. 13, 1981).

[88] Pub. L. No. 105-34 (August 5, 1997).

Table 4.–Estate and Gift Tax Rates and Exemption Amounts, 1975-2010

Year	Annual gift exclusion	Exemption Value of Unified Credit (gift exemption when not unified)	Threshold of Highest Statutory Tax Rate	Highest Statutory Tax Rate (percent)
1975-1976	$3,000	$60,000 ($30,000)	$10 million	57.75 gift; 77 estate[1]
1977	$3,000	$120,667	$5 million	70
1978	$3,000	$134,000	$5 million	70
1979	$3,000	$147,333	$5 million	70
1980	$3,000	$161,563	$5 million	70
1981	$10,000	$175,625	$5 million	70
1982	$10,000	$225,000	$4 million	65
1983	$10,000	$275,000	$3.5 million	60
1984	$10,000	$325,000	$3 million	55
1985	$10,000	$400,000	$3 million	55
1986	$10,000	$500,000	$3 million	55
1987-1997	$10,000	$600,000	$3 million	55
1998	$10,000	$625,000	$3 million	55
1999	$10,000	$650,000	$3 million	55
2000-2001	$10,000	$675,000	$3 million	55
2002	$11,000	$1 million	$2.5 million	50
2003	$11,000	$1 million	$2 million	49
2004	$11,000	$1.5 million ($1 million)	$2 million	48
2005	$11,000	$1.5 million ($1 million)	$2 million	47
2006	$12,000	$2 million ($1 million)	$2 million	46
2007-2008	$12,000	$2 million ($1 million)	$1.5 million	45
2009	$13,000	$3.5 million ($1 million)	$1.5 million	45
2010	$13,000	No estate tax ($1 million)	$1.5 million	35 gift; No estate tax[3]
2011	$13,000	$1 million	$3 million	55

E. Excise Taxes

The Federal tax system imposes excise taxes on selected goods and services. In addition to excise taxes the primary purpose of which is revenue production, excise taxes also are imposed to promote adherence to other policies (e.g. penalty excise taxes). Generally, excise taxes are taxes imposed on a per unit or ad valorem (i.e., percentage of price) basis on the production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous activities and products, coal, telephone communications, certain wagers, and vehicles lacking in fuel efficiency.[89] The largest excise taxes in terms of revenue (for fiscal year 2008) are those for gasoline motor fuels ($25.1 billion), diesel motor fuel ($9.3 billion), domestic air ticket taxes ($8.2 billion) and domestic cigarettes ($6.6 billion).

Revenues from certain Federal excise taxes are dedicated to trust funds (e.g., the Highway Trust Fund) for designated expenditure programs and revenues from other excise taxes (e.g., alcoholic beverages) go to the General Fund for general purpose expenditures.

The following summarizes the key changes to the major excise taxes since 1975.

<u>**Alcohol**</u>

Taxes are imposed at different rates for distilled spirits, wines, and beer and are imposed on these products when produced or imported.

1. Distilled Spirits

In 1975 the excise tax rate on alcohol was the same as it had been since 1951 at $10.50 per proof gallon, a rate that had been set to raise revenue for the Korean War. Domestically bottled alcohols were taxed at the proof gallon[90] rate by multiplying the proof of the spirit by the tax rate. Thus a 100 proof spirit was taxed at $10.50 per gallon, while an 80 proof spirit was taxed at $8.40 per gallon (0.8 * 10.50). Alcohol that was bottled before being imported, however, was taxed using the wine gallon method such that all bottles were taxed at $10.50 per gallon regardless of proof.

The Trade Agreements Act of 1979[91] (the "1979 Act") repealed the wine gallon method of taxing bottled distilled spirit imports so that import bottles are now taxed at the proof gallon, the same as domestically bottled alcohol. The 1979 Act also ended the complicated system of joint control of distilleries, which required the presence of IRS agents in order for many actions

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[89] See, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B)of the Internal Revenue Code of 1986,* (JCS-3-01), April 2001, pp. 478-516 for a detailed description of the various Federal excise taxes.

[90] A proof gallon is one liquid gallon of spirits that is 50% alcohol at 60 degrees Fahrenheit.

[91] Pub. L. No. 96-39.

to be performed to insure collection of taxes, and instead treated distilleries as bonded premises.[92]

By 1984 the excise tax, in constant dollars, had decreased by more than 70 percent since 1951. Congress increased the tax by $2.00 to $12.50 per proof gallon in the 1984 Tax Reform Act.

As part of the Omnibus Budget Reconciliation Act of 1990,[93] Congress raised the rate on distilled spirits by $1.00 to $13.50, the present rate.

2. Beer

In 1975 the excise tax rate on beer was $9.00 per barrel, the rate from 1951 when excise taxes were increased to raise revenue for the Korean War.

In 1977, a special tax rate for small brewers was created. The lower rate of $7.00 per barrel applies to brewers who brew fewer than two million barrels a year. The lower rate applies to the first 60,000 barrels removed during the calendar year while the normal rate applies to all barrels after the first 60,000.

The Revenue Reconciliation Act of 1990[94] doubled the rate, making the new rate $18.00 per barrel. The small producer exception was retained.

3. Wine

The tax rate on wine in 1975 was set at a variety of rates depending on type and proof of the wine and ranged from $0.17 per wine gallon for still wines to $3.40 per wine gallon on sparkling wines. Wines with over 24 percent alcohol were taxed the same as distilled spirits. These rates had been in effect since 1951.

The rates remained in effect until the Revenue Reconciliation Act of 1990[95] when the rates were raised by $0.90 per wine gallon for all wines, except sparkling wines which remained at $3.40 per wine gallon. The Act provided for a credit of up to $0.90 per wine gallon for small domestic producers (excluding sparkling wine) for the first 100,000 gallons of wine so that the tax remained roughly the same for those producers.

Until 1997 hard cider was taxed at the same rate as wine with alcohol less than 14 percent, or $1.07 per wine gallon. The tax rate for hard cider was decoupled from the wine rate

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[92] In a bonded premises system the tax is determined and collected after bottling and when shipped. The changes also placed the burden of tax collection on the distilleries, rather than IRS agents, by requiring the distilleries to keep detailed and adequate records for inspection.

[93] Pub. L. No. 101-508.

[94] *Ibid.*

[95] *Ibid.*

and lowered to 22.6 cents per gallon under the Taxpayer Relief Act of 1997 (the "1997 Act"). The 1997 Act also significantly lowered the credit for small producers of hard cider, from the $0.90 cent credit per wine gallon applicable to wines to a $0.056 per gallon credit. Table 5 below, shows the alcohol excise tax rates.

Table 5.–Alcohol Excise Taxes

Type of Alcohol	1975	1985	1990-Present
Distilled Spirits (per proof gallon)	$10.50	$12.50	$13.50
Beer (per barrel)	9	9	18
Wines (per wine gallon)			
"Still wines" not more than 14 percent alcohol	.17	.17	1.07
"Still wines" 14-21% alcohol	.67	.67	1.57
"Still wines" 21-24% alcohol	2.25	2.25	3.15
"Still wines" more than 24% alcohol	Taxed as spirits	Taxed as Spirits	Taxed as Spirits
Champagne and sparkling wines	3.40	3.40	3.40
Artificially carbonated wines	2.40	2.40	3.30

__Cigarettes__

In 1975 the excise tax rate on small cigarettes was eight cents per pack, the same rate that had been in effect since 1951.[96] In Tax Equity and Fiscal Responsibility Act of 1982[97] the rate was doubled to 16 cents per pack, though the increase did not increase the per-pack tax in real terms over the level in 1951.[98] The next time the rates were raised was in the Revenue Reconciliation Act of 1990,[99] which increased the rate by eight cents per pack, half to take effect in 1991 and half to take effect in 1993.

[96] Small cigarettes are those weighing three pounds or less per thousand.

[97] Pub. L. No. 97-248.

[98] The tax rate in 1951 was eight cents per pack.

[99] Pub. L. No. 101-508.

The next tax increase came in the Balanced Budget Act of 1997[100] which again increased the rates in two stages. The first stage was a 10 cent increase in 2000, followed by an additional increase of five cents in 2002, leaving the rate at 39 cents per pack.

In 2009, the cigarette tax was raised roughly 156 percent to nearly $1.01 per pack as part of The Children's Health Insurance Program Reauthorization Act of 2009[101] in order to raise revenue. Table 6 below, shows the cigarette excise tax rates from 1975.

Table 6.–Cigarette Excise Tax Rates

Year	1975-1981	1982-1990	1991-1992	1993-1996	1997-2008	2009-Present
Small Cigarettes Tax Rate (cents per pack)	8	16[1]	20[2]	24[3]	39[4]	100.66[5]

Motor Fuels

4. Gasoline

The tax on gasoline in 1975 was 4 cents per gallon and the revenues raised from the tax were allocated to the Highway Trust Fund ("HTF"), created by the Highway Revenue Act of 1956.[102]

The gasoline tax was raised from 4 cents per gallon to nine cents per gallon in 1983 for the purpose of improving and repairing the nation's highways by the Surface Transportation Assistance Act of 1982.[103]

In 1986, the Resource Conservation and Recovery Act[104] created the Leaking Underground Storage Tank Trust Fund ("LUST"), which is funded by a 0.1 cent tax per gallon of

[100] Pub. L. No. 105-33.

[101] Pub. L. No. 111-3.

[102] Pub. L. No. 84-627.

[103] Pub. L. No. 97-424.

[104] Pub. L. No. 94-580.

gasoline. This raised the rate to 9.1 cents per gallon. The LUST tax has expired and been renewed multiple times since 1986.[105]

The next raise in the gasoline tax came in the Omnibus Budget Reconciliation Act of 1990 and was a measure taken in order to contribute to deficit reduction.[106] The gasoline tax at that time was increased to 14.1 cents per gallon, and the five cent increase was allocated half to the HTF and half to deficit reduction. The half allocated to the General Fund was a temporary allocation to end in 1995.

In 1993, the tax was increased to 18.4 cents per gallon by the Omnibus Budget Reconciliation Act of 1993.[107] The additional tax of 4.3 cents per gallon was earmarked to be used not for highway improvement but only for deficit reduction, and thus was allocated to the General Fund. The Taxpayer Relief Act of 1997 reallocated the 4.3 cent increase to the HTF.[108]

The current rate of 18.4 cents per gallon consists of 18.3 cents per gallon allocated to the HTF[109] and 0.1 cent per gallon allocated to the LUST fund.

5. Diesel

The tax on diesel fuel in 1975 was the same as the tax on gasoline,[110] and it too was raised from four cents to nine cents in 1983.[111] The tax was then increased again, without a corresponding increase in gasoline tax, in the Deficit Reduction Act of 1984.[112] At this time the tax was raised to 15 cents per gallon, in exchange for a reduction in the highway use tax on heavy trucks. The LUST tax in 1986 raised the tax to 15.1 cents per gallon.[113]

The diesel tax was raised by five cents in 1990 at the same time as the gasoline tax increase, similarly with half allocated to the General Fund and half allocated to the HTF.[114]

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[105] The LUST tax expired from September 1990 until November 1990, January 1996 through September 1997, and April 2005 through September 2005. During those periods of time, the tax was .1 cent lower than indicated in the table.

[106] Pub. L. No. 101-508.

[107] Pub. L. No. 103-66.

[108] Pub. L. No. 105-34.

[109] 2.86 cents of this amount are allocated to the Mass Transit Account, a special account within the HTF.

[110] Pub. L. No. 84-627.

[111] Pub. L. No. 97-424

[112] Pub. L. No. 98-369.

[113] Pub. L. No. 94-580.

[114] Pub. L. No. 101-508.

The tax on diesel was again raised by the same amount as the gasoline tax, 4.3 cents, in 1993.[115]

As part of the Omnibus Budget Reconciliation Act of 1993, in order to prevent tax evasion schemes, the government moved the point of collection of the tax from the wholesale to the terminal level and mandated the dyeing of low-tax diesels.[116]

Farmers are exempt from paying the diesel excise tax when the diesel is used for farming purposes. Until 2005, farmers used a Certificate of Farming Use to buy clear (non-dyed) diesel without paying the tax. As part of the Safe, Accountable, Flexible and Efficient Transportation Equity Act[117] in 2005, farmers were required to pay the tax upfront and could later file a claim for a refund for the amounts used for farming purposes. Table 7 below, shows motor fuel excise tax rates from 1975.

Table 7.–Motor Fuel Excise Tax Rates

Year	1975	1983	1984	1987	1990	1993-Present
Gasoline (cents per gallon)	4	9	9	9.1	14.1	18.4
Diesel (cents per gallon)	4	9	15	15.1	20.1	24.4

[115] Pub. L. No. 103-66.

[116] Diesel used for off-road use such as construction and heating is generally not subject to tax and must be dyed red. State and local governments are exempt from the diesel tax even for highway use and generally must use diesel that is dyed blue.

[117] Pub. L. No. 109-59.

II. APPENDIX

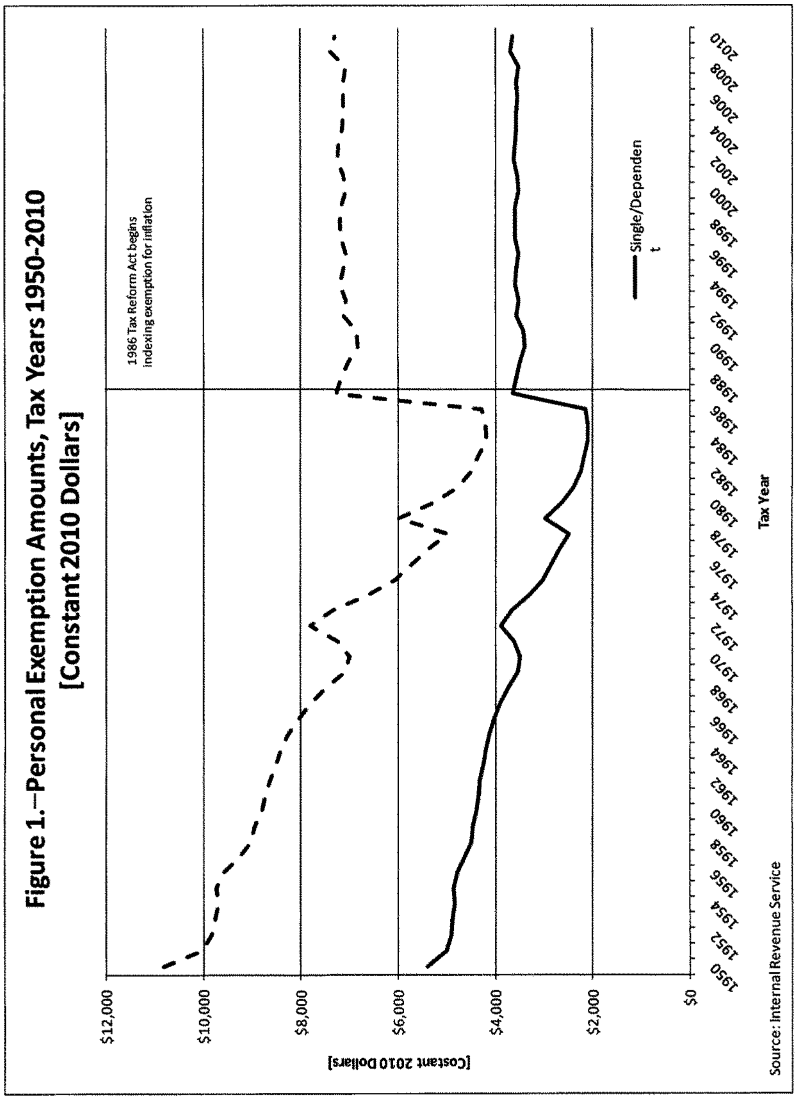


Figure 1.—Personal Exemption Amounts, Tax Years 1950-2010 [Constant 2010 Dollars]

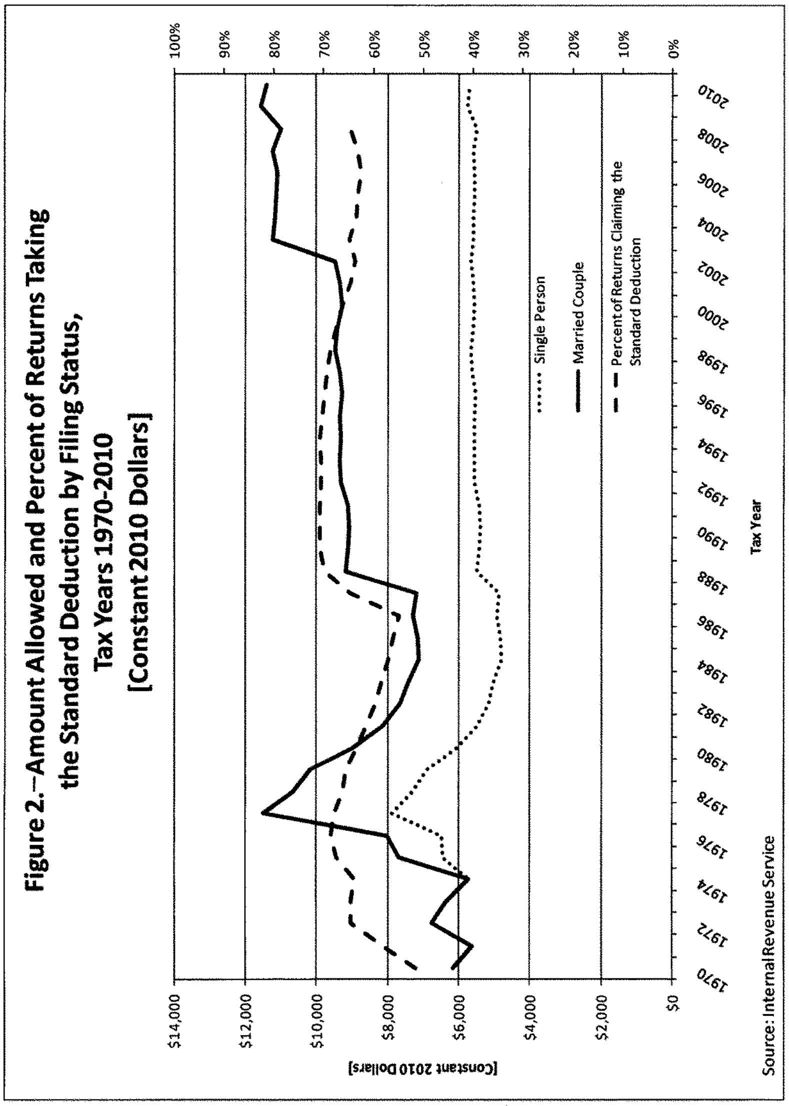
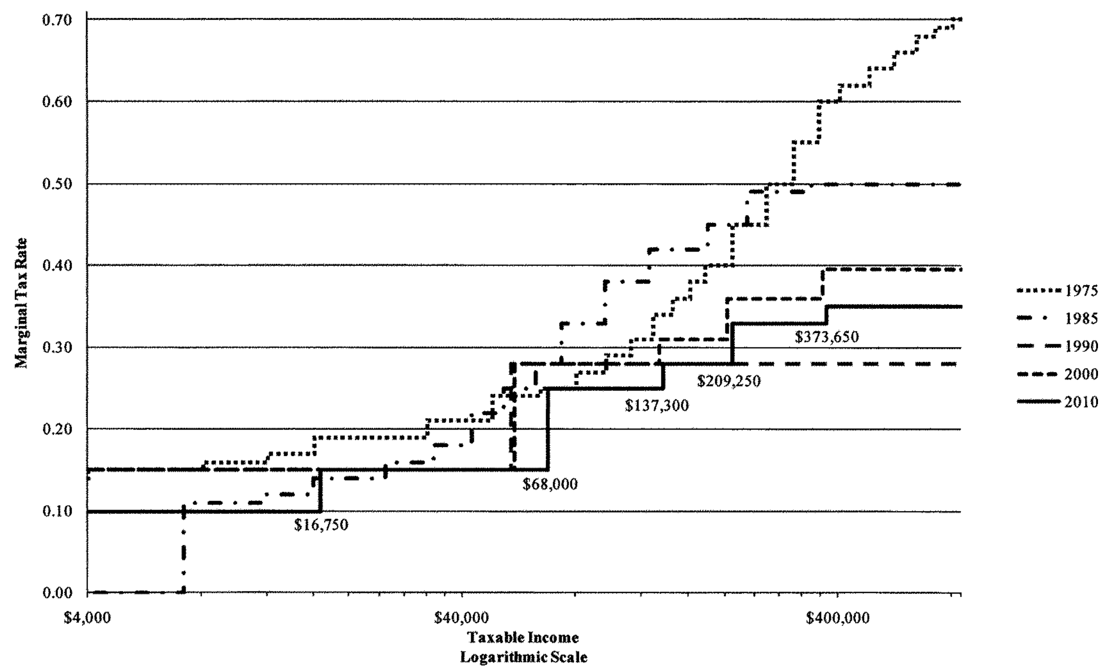


Figure 2.--Amount Allowed and Percent of Returns Taking the Standard Deduction by Filing Status, Tax Years 1970-2010 [Constant 2010 Dollars]

Source: Internal Revenue Service

Figure 3.-Individual Rate Bracket Structure for Married Individuals Filing Joint Returns and Surviving Spouses
(Real 2010 Dollars)



Note: The dollar thresholds for the rate brackets in 2010 are shown on the chart.

Table 1.–Number and Share of Returns Claiming Standard Deduction Versus Itemized Deductions, Tax Years 1950-2008 [Millions of Returns]					
Year	Total Number of Returns	Number of Returns Claiming Standard Deduction	(% of Total)	Number of Returns Claiming Itemized Deduction	(% of Total)
1950	53.1	42.7	80.4%	10.3	19.4%
1951	55.4	43.9	79.2%	11.6	20.9%
1952	56.5	43.7	77.3%	12.8	22.7%
1953	57.8	43.4	75.1%	14.4	24.9%
1954	56.7	41	72.3%	15.7	27.7%
1955	58.3	40.9	70.2%	16.9	29.0%
1956	59.2	40.3	68.1%	18.5	31.3%
1957	59.8	39.3	65.7%	20.2	33.8%
1958	59.1	37.9	64.1%	20.8	35.2%
1959	60.3	37.3	61.9%	22.5	37.3%
1960	61	36.5	59.8%	24.1	39.5%
1961	61.5	35.8	58.2%	25.3	41.1%
1962	62.7	35.8	57.1%	26.5	42.3%
1963	63.9	35.4	55.4%	28.2	44.1%
1964	65.4	38	58.1%	26.9	41.1%
1965	67.6	39.3	58.1%	27.9	41.3%
1966	70.2	41.2	58.7%	28.6	40.7%
1967	71.7	41.5	57.9%	29.8	41.6%
1968	73.7	41.3	56.0%	32	43.4%
1969	75.8	40.5	53.4%	34.9	46.0%
1970	74.3	38.4	51.7%	35.4	47.6%
1971	74.6	43.5	58.3%	30.7	41.2%
1972	77.6	50.2	64.7%	27	34.8%
1973	80.7	52.2	64.7%	28	34.7%
1974	83.3	53.2	63.9%	29.6	35.5%
1975	82.2	55.5	67.5%	26.1	31.8%
1976	84.7	58.2	68.7%	26	30.7%
1977	86.6	58.8	67.9%	22.9	26.4%
1978	89.8	59.5	66.3%	25.8	28.7%
1979	92.7	60.7	65.5%	26.5	28.6%
1980	93.9	59.5	63.4%	29	30.9%
1981	95.4	58.7	61.5%	31.6	33.1%
1982	95.3	56.9	59.7%	33.4	35.0%
1983	96.3	56.2	58.4%	35.2	36.6%
1984	99.4	56.7	57.0%	38.2	38.4%
1985	101.7	57	56.0%	39.8	39.1%
1986	103	56.5	54.9%	40.7	39.5%
1987	107	69.1	64.6%	35.6	33.3%
1988	109.7	76.5	69.7%	31.9	29.1%
1989	112.1	79.3	70.7%	32	28.5%

Table 1.--Number and Share of Returns Claiming Standard Deduction Versus Itemized Deductions, Tax Years 1950-2008 (cont'd) [Millions of Returns]					
Year	Total Number of Returns	Number of Returns Claiming Standard Deduction	(% of Total)	Number of Returns Claiming Itemized Deduction	(% of Total)
1990	113.7	80.6	70.9%	32.2	28.3%
1991	114.7	81.3	70.9%	32.5	28.3%
1992	113.6	80.1	70.5%	32.5	28.6%
1993	114.6	80.8	70.5%	32.8	28.6%
1994	115.9	81.9	70.7%	33	28.5%
1995	118.2	83.2	70.4%	34	28.8%
1996	120.4	84	69.8%	35.4	29.4%
1997	122.4	84.8	69.3%	36.6	29.9%
1998	124.8	85.6	68.6%	38.2	30.6%
1999	127.1	85.8	67.5%	40.2	31.6%
2000	129.4	85.7	66.2%	42.5	32.8%
2001	130.3	84.2	64.6%	44.6	34.2%
2002	130.1	82.7	63.6%	45.6	35.0%
2003	130.4	84.6	64.9%	43.9	33.7%
2004	132.2	84	63.5%	46.3	35.0%
2005	134.4	84.8	63.1%	47.8	35.6%
2006	138.4	86.6	62.6%	49.1	35.5%
2007	143	90.5	63.3%	50.5	35.3%
2008 [p]	142.4	92	64.6%	48	33.7%

Source: Internal Revenue Service

[p] = preliminary

[3] Series revised, starting with the Spring 1997 SOI Bulletin, to exclude from the standard deduction statistics, the relatively small number of returns with no subject gross income and no deductions. Previously, these returns were classified as if they sshowed a standard deduction. For the 1977-1986 statistics, the standard deduction is the "zero bracket amount" (reported on returns with onoy a "zero bracket amount"). Such an amount was also included for a small number of returns for 1987-1988 for years in which the "zero bracket amount" was in effect, frequencies shown for standard deduction returns were derived by substracting the number reporting an income tax liability, but no itemized deductions, from the total of all returns. For 1950-1952, returns with no deductions and, for 1950-1954, the samll number with no income, regardless in these two categories were excluded from all the deduction statistics in this table.

Table 2.–Federal Individual Income Tax Rates for 1975

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $500	14% of the taxable income
Over $500 but not over $1,000	$70 plus 15% of the excess over $500
Over $1,000 but not over $1,500	$145 plus 16% of the excess over $1,000
Over $1,500 but not over $2,000	$225 plus 17% of the excess over $1,500
Over $2,000 but not over $4,000	$310 plus 19% of the excess over $2,000
Over $4,000 but not over $6,000	$690 plus 21% of the excess over $4,000
Over $6,000 but not over $8,000	$1,110 plus 24% of the excess over $6,000
Over $8,000 but not over $10,000	$1,590 plus 25% of the excess over $8,000
Over $10,000 but not over $12,000	$2,090 plus 27% of the excess over $10,000
Over $12,000 but not over $14,000	$2,630 plus 29% of the excess over $12,000
Over $14,000 but not over $16,000	$3,210 plus 31% of the excess over $14,000
Over $16,000 but not over $18,000	$3,830 plus 34% of the excess over $16,000
Over $18,000 but not over $20,000	$4,510 plus 36% of the excess over $18,000
Over $20,000 but not over $22,000	$5,230 plus 38% of the excess over $20,000
Over $22,000 but not over $26,000	$5,990 plus 40% of the excess over $22,000
Over $26,000 but not over $32,000	$7,590 plus 45% of the excess over $26,000
Over $32,000 but not over $38,000	$10,290 plus 50% of the excess over $32,000
Over $38,000 but not over $44,000	$13,290 plus 55% of the excess over $38,000
Over $44,000 but not over $50,000	$16,590 plus 60% of the excess over $44,000
Over $50,000 but not over $60,000	$20,190 plus 62% of the excess over $50,000
Over $60,000 but not over $70,000	$26,390 plus 64% of the excess over $60,000
Over $70,000 but not over $80,000	$32,790 plus 66% of the excess over $70,000
Over $80,000 but not over $90,000	$39,390 plus 68% of the excess over $80,000
Over $90,000 but not over $100,000	$46,190 plus 69% of the excess over $90,000
Over $100,000	$53,090 plus 70% of the excess over $100,000

If taxable income is:	Then income tax equals:
Heads of Households	
Not over $1,000	14% of the taxable income
Over $1,000 but not over $2,000	$140 plus 16% of the excess over $1,000
Over $2,000 but not over $4,000	$300 plus 18% of the excess over $2,000
Over $4,000 but not over $6,000	$660 plus 19% of the excess over $4,000
Over $6,000 but not over $8,000	$1,040 plus 22% of the excess over $6,000
Over $8,000 but not over $10,000	$1,480 plus 23% of the excess over $8,000
Over $10,000 but not over $12,000	$1,940 plus 25% of the excess over $10,000
Over $12,000 but not over $14,000	$2,440 plus 27% of the excess over $12,000
Over $14,000 but not over $16,000	$2,980 plus 28% of the excess over $14,000
Over $16,000 but not over $18,000	$3,540 plus 31% of the excess over $16,000
Over $18,000 but not over $20,000	$4,160 plus 32% of the excess over $18,000
Over $20,000 but not over $22,000	$4,800 plus 35% of the excess over $20,000
Over $22,000 but not over $24,000	$5,500 plus 36% of the excess over $22,000
Over $24,000 but not over $26,000	$6,220 plus 38% of the excess over $24,000
Over $26,000 but not over $28,000	$6,980 plus 41% of the excess over $26,000
Over $28,000 but not over $32,000	$7,800 plus 42% of the excess over $28,000
Over $32,000 but not over $36,000	$9,480 plus 45% of the excess over $32,000
Over $36,000 but not over $38,000	$11,280 plus 48% of the excess over $36,000
Over $38,000 but not over $40,000	$12,240 plus 51% of the excess over $38,000
Over $40,000 but not over $44,000	$13,260 plus 52% of the excess over $40,000
Over $44,000 but not over $50,000	$15,340 plus 55% of the excess over $44,000
Over $50,000 but not over $52,000	$18,640 plus 56% of the excess over $50,000
Over $52,000 but not over $64,000	$19,760 plus 58% of the excess over $52,000
Over $64,000 but not over $70,000	$26,720 plus 59% of the excess over $64,000
Over $70,000 but not over $76,000	$30,260 plus 61% of the excess over $70,000
Over $76,000 but not over $80,000	$33,920 plus 62% of the excess over $76,000
Over $80,000 but not over $88,000	$36,400 plus 63% of the excess over $80,000
Over $88,000 but not over $100,000	$41,400 plus 64% of the excess over $88,000
Over $100,000 but not over $120,000	$49,120 plus 66% of the excess over $100,000
Over $120,000 but not over $140,000	$62,320 plus 67% of the excess over $120,000
Over $140,000 but not over $160,000	$75,720 plus 68% of the excess over $140,000

If taxable income is:	Then income tax equals:
Over $160,000 but not over $180,000	$89,320 plus 69% of the excess over $160,000
Over $180,000	$103,120 plus 70% of the excess over $180,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $1,000	14% of the taxable income
Over $1,000 but not over $2,000	$140 plus 15% of the excess over $1,000
Over $2,000 but not over $3,000	$290 plus 16% of the excess over $2,000
Over $3,000 but not over $4,000	$450 plus 17% of the excess over $3,000
Over $4,000 but not over $8,000	$620 plus 19% of the excess over $4,000
Over $8,000 but not over $12,000	$1,380 plus 22% of the excess over $8,000
Over $12,000 but not over $16,000	$2,260 plus 25% of the excess over $12,000
Over $16,000 but not over $20,000	$3,260 plus 28% of the excess over $16,000
Over $20,000 but not over $24,000	$4,380 plus 32% of the excess over $20,000
Over $24,000 but not over $28,000	$5,660 plus 36% of the excess over $24,000
Over $28,000 but not over $32,000	$7,100 plus 39% of the excess over $28,000
Over $32,000 but not over $36,000	$8,660 plus 42% of the excess over $32,000
Over $36,000 but not over $40,000	$10,340 plus 45% of the excess over $36,000
Over $40,000 but not over $44,000	$12,140 plus 48% of the excess over $40,000
Over $44,000 but not over $52,000	$14,060 plus 50% of the excess over $44,000
Over $52,000 but not over $64,000	$18,060 plus 53% of the excess over $52,000
Over $64,000 but not over $76,000	$24,420 plus 55% of the excess over $64,000
Over $76,000 but not over $88,000	$31,020 plus 58% of the excess over $76,000
Over $88,000 but not over $100,000	$37,980 plus 60% of the excess over $88,000
Over $100,000 but not over $120,000	$45,180 plus 62% of the excess over $100,000
Over $120,000 but not over $140,000	$57,580 plus 64% of the excess over $120,000
Over $140,000 but not over $160,000	$70,380 plus 66% of the excess over $140,000
Over $160,000 but not over $180,000	$83,580 plus 68% of the excess over $160,000
Over $180,000 but not over $200,000	$97,180 plus 69% of the excess over $180,000
Over $200,000	$110,980 plus 70% of the excess over $200,000

Married Individuals Filing Separate Returns	
Not over $500	14% of the taxable income
Over $500 but not over $1,000	$70 plus 15% of the excess over $500
Over $1,000 but not over $1,500	$145 plus 16% of the excess over $1,000
Over $1,500 but not over $2,000	$225 plus 17% of the excess over $1,500
Over $2,000 but not over $4,000	$310 plus 19% of the excess over $2,000
Over $4,000 but not over $6,000	$690 plus 22% of the excess over $4,000
Over $6,000 but not over $8,000	$1,130 plus 25% of the excess over $6,000
Over $8,000 but not over $10,000	$1,630 plus 28% of the excess over $8,000
Over $10,000 but not over $12,000	$2,190 plus 32% of the excess over $10,000
Over $12,000 but not over $14,000	$2,830 plus 36% of the excess over $12,000
Over $14,000 but not over $16,000	$3,550 plus 39% of the excess over $14,000
Over $16,000 but not over $18,000	$4,330 plus 42% of the excess over $16,000
Over $18,000 but not over $20,000	$5,170 plus 45% of the excess over $18,000
Over $20,000 but not over $22,000	$6,070 plus 48% of the excess over $20,000
Over $22,000 but not over $26,000	$7,030 plus 50% of the excess over $22,000
Over $26,000 but not over $32,000	$9,030 plus 53% of the excess over $26,000
Over $32,000 but not over $38,000	$12,210 plus 55% of the excess over $32,000
Over $38,000 but not over $44,000	$15,510 plus 58% of the excess over $38,000
Over $44,000 but not over $50,000	$18,990 plus 60% of the excess over $44,000
Over $50,000 but not over $60,000	$22,590 plus 62% of the excess over $50,000
Over $60,000 but not over $70,000	$28,790 plus 64% of the excess over $60,000
Over $70,000 but not over $80,000	$35,190 plus 66% of the excess over $70,000
Over $80,000 but not over $90,000	$41,790 plus 68% of the excess over $80,000
Over $90,000 but not over $100,000	$48,590 plus 69% of the excess over $90,000
Over $100,000	$55,490 plus 70% of the excess over $100,000

Table 3.–Federal Individual Income Tax Rates for 1985

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $2,390	No tax
Over $2,390 but not over $3,540	11% of the excess over $2,390
Over $3,540 but not over $4,580	$126.50 plus 12% of the excess over $3,540
Over $4,580 but not over $6,760	$251.30 plus 14% of the excess over $4,580
Over $6,760 but not over $8,850	$556.50 plus 15% of the excess over $6,760
Over $8,850 but not over $11,240	$870 plus 16% of the excess over $8,850
Over $11,240 but not over $13,430	$1,252.40 plus 18% of the excess over $11,240
Over $13,430 but not over $15,610	$1,646.60 plus 20% of the excess over $13,430
Over $15,610 but not over $18,940	$2,082.60 plus 23% of the excess over $15,610
Over $18,940 but not over $24,460	$2,848.50 plus 26% of the excess over $18,940
Over $24,460 but not over $29,970	$4,283.70 plus 30% of the excess over $24,460
Over $29,970 but not over $35,490	$5,936.70 plus 34% of the excess over $29,970
Over $35,490 but not over $43,190	$7,813.50 plus 38% of the excess over $35,490
Over $43,190 but not over $57,550	$10,739.50 plus 42% of the excess over $43,190
Over $57,550 but not over $85,130	$16,770.70 plus 48% of the excess over $57,550
Over $85,130	$30,009.10 plus 50% of the excess over $85,130
Heads of Households	
Not over $2,390	No tax
Over $2,390 but not over $4,580	11% of the excess over $2,390
Over $4,580 but not over $6,760	$240.90 plus 12% of the excess over $4,580
Over $6,760 but not over $9,050	$502.50 plus 14% of the excess over $6,760
Over $9,050 but not over $12,280	$823.10 plus 17% of the excess over $8,850
Over $12,280 but not over $15,610	$1,372.20 plus 18% of the excess over $12,280
Over $15,610 but not over $18,940	$1,971.60 plus 20% of the excess over $15,610
Over $18,940 but not over $24,460	$2,637.60 plus 24% of the excess over $18,940
Over $24,460 but not over $29,970	$3,962.40 plus 28% of the excess over $24,460
Over $29,970 but not over $35,490	$5,505.20 plus 32% of the excess over $29,970
Over $35,490 but not over $46,520	$7,271.60 plus 35% of the excess over $35,490
Over $46,520 but not over $63,070	$11,132.10 plus 42% of the excess over $46,520

If taxable income is:	Then income tax equals:
Over $63,070 but not over $85,130	$18,083.10 plus 45% of the excess over $63,070
Over $85,130 but not over $112,720	$28,010.10 plus 48% of the excess over $85,130
Over $112,720	$41,253.30 plus 50% of the excess over $112,720
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $3,540	No tax
Over $3,540 but not over $5,720	11% of the excess over $3,540
Over $5,720 but not over $7,910	$239.80 plus 12% of the excess over $5,720
Over $7,910 but not over $12,390	$502.60 plus 14% of the excess over $7,910
Over $12,390 but not over $16,650	$1,129.80 plus 16% of the excess over $12,390
Over $16,650 but not over $21,020	$1,811.40 plus 18% of the excess over $16,650
Over $21,020 but not over $25,600	$2,598 plus 22% of the excess over $21,020
Over $25,600 but not over $31,120	$3,605.60 plus 25% of the excess over $25,600
Over $31,120 but not over $36,630	$4,985.60 plus 28% of the excess over $31,120
Over $36,630 but not over $47,670	$6,528.40 plus 33% of the excess over $36,630
Over $47,670 but not over $62,450	$10,171.60 plus 38% of the excess over $47,670
Over $62,450 but not over $89,090	$15,788 plus 42% of the excess over $62,450
Over $89,090 but not over $113,860	$26,976.80 plus 45% of the excess over $89,090
Over $113,860 but not over $169,020	$38,123.30 plus 49% of the excess over $113,860
Over $169,020	$65,151.70 plus 50% of the excess over $169,020
Married Individuals Filing Separate Returns	
Not over $1,770	No tax
Over $1,770 but not over $2,860	11% of the excess over $1,770
Over $2,860 but not over $3,955	$119.90 plus 12% of the excess over $2,860
Over $3,955 but not over $6,195	$251.30 plus 14% of the excess over $3,955
Over $6,195 but not over $8,325	$564.90 plus 16% of the excess over $6,195
Over $8,325 but not over $10,510	$905.70 plus 18% of the excess over $8,325
Over $10,510 but not over $12,800	$1,299 plus 22% of the excess over $10,510
Over $12,800 but not over $15,560	$1,802.80 plus 25% of the excess over $12,800
Over $15,560 but not over $18,315	$2,492.80 plus 28% of the excess over $15,560
Over $18,315 but not over $23,835	$3,264.20 plus 33% of the excess over $18,315
Over $23,835 but not over $31,225	$5,085.80 plus 38% of the excess over $23,835

If taxable income is:	Then income tax equals:
Over $31,225 but not over $44,545	$7,894 plus 42% of the excess over $31,225
Over $44,545 but not over $56,930	$13,488.40 plus 45% of the excess over $44,545
Over $56,930 but not over $84,510	$19,061.65 plus 49% of the excess over $56,930
Over $84,510	$32,575.85 plus 50% of the excess over $84,510

Table 4.–Federal Individual Income Tax Rates for 1990

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $19,450	15% of the taxable income
Over $19,450	$2,917.50 plus 28% of the excess over $19,450[1]
Heads of Households	
Not over $26,050	15% of the taxable income
Over $26,050	$3,907.50 plus 28% of the excess over $26,050[1]
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $32,450	15% of the taxable income
Over $32,450	$4,867.50 plus 28% of the excess over $32,450[1]
Married Individuals Filing Separate Returns	
Not over $16,225	15% of the taxable income
Over $16,225	$2,433.75 plus 28% of the excess over $16,225[1]

[1] For taxable incomes above certain thresholds the combined benefit of the 15-percent rate bracket and any applicable personal exemptions of the taxpayer are recaptured through a five percentage point increase in the income tax rate resulting in an marginal tax rate of 33 percent. After the combined benefit of the 15-percent rate bracket and any applicable personal exemptions is recaptured the marginal rate again becomes 28 percent.

Table 5.–Federal Individual Income Tax Rates for 1995

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $23,350	15% of the taxable income
Over $23,350 but not over $56,550	$3,502.50 plus 28% of the excess over $23,350
Over $56,550 but not over $117,950	$12,798.50 plus 31% of the excess over $56,550
Over $117,950 but not over $256,500	$31,832.50 plus 36% of the excess over $117,950
Over $256,500	$81,710.50 plus 39.6% of the excess over $256,500
Heads of Households	
Not over $31,250	15% of the taxable income
Over $31,250 but not over $80,750	$4,687.50 plus 28% of the excess over $31,250
Over $80,750 but not over $130,800	$18,547.50 plus 31% of the excess over $80,750
Over $130,800 but not over $256,500	$34,063 plus 36% of the excess over $130,800
Over $256,500	$79,315 plus 39.6% of the excess over $256,500
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $39,000	15% of the taxable income
Over $39,000 but not over $94,250	$5,850 plus 28% of the excess over $39,000
Over $94,250 but not over $143,600	$21,320 plus 31% of the excess over $94,250
Over $143,600 but not over $256,500	$36,618.50 plus 36% of the excess over $143,600
Over $256,500	$77,262.50 plus 39.6% of the excess over $256,500
Married Individuals Filing Separate Returns	
Not over $19,500	15% of the taxable income
Over $19,500 but not over $47,125	$2,925 plus 28% of the excess over $19,500
Over $47,125 but not over $71,800	$10,660 plus 31% of the excess over $47,125
Over $71,800 but not over $128,250	$18,309.25 plus 36% of the excess over $71,800
Over $128,250	$38,631.25 plus 39.6% of the excess over $128,250

Table 6.–Federal Individual Income Tax Rates for 2000

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $26,250	15% of the taxable income
Over $26,250 but not over $63,550	$3,937.50 plus 28% of the excess over $26,250
Over $63,550 but not over $132,600	$14,381.50 plus 31% of the excess over $63,550
Over $132,600 but not over $288,350	$35,787 plus 36% of the excess over $132,600
Over $288,350	$91,857 plus 39.6% of the excess over $288,350
Heads of Households	
Not over $35,150	15% of the taxable income
Over $35,150 but not over $90,800	$5,272.50 plus 28% of the excess over $35,150
Over $90,800 but not over $140,050	$20,854.50 plus 31% of the excess over $90,800
Over $140,050 but not over $ 288,350	$38,292 plus 36% of the excess over $140,050
Over $288,350	$89,160 plus 39.6% of the excess over $288,350
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $43,850	15% of the taxable income
Over $43,850 but not over $105,950	$6,577.50 plus 28% of the excess over $43,850
Over $105,950 but not over $161,450	$23,965.50 plus 31% of the excess over $105,950
Over $161,450 but not over $288,350	$41,170.50 plus 36% of the excess over $161,450
Over $288,350	$86,854.50 plus 39.6% of the excess over $288,350
Married Individuals Filing Separate Returns	
Not over $21,965	15% of the taxable income
Over $21,965 but not over $52,975	$3,288.75 plus 28% of the excess over $21,965
Over $52,975 but not over $80,725	$11,982.75 plus 31% of the excess over $52,975
Over $80,725 but not over $144,175	$20,584.50 plus 36% of the excess over $80,725
Over $144,175	$43,427.25 plus 39.6% of the excess over $144,175

Table 7.–Federal Individual Income Tax Rates for 2010

If taxable income is:	**Then income tax equals:**
Single Individuals	
Not over $8,375	10% of the taxable income
Over $8,375 but not over $34,000	$837.50 plus 15% of the excess over $8,375
Over $34,000 but not over $82,400	$4,681.25 plus 25% of the excess over $34,000
Over $82,400 but not over $171,850	$16,781.25 plus 28% of the excess over $82,400
Over $171,850 but not over $373,650	$41,827.25 plus 33% of the excess over $171,850
Over $373,650	$108,421.25 plus 35% of the excess over $373,650
Heads of Households	
Not over $11,950	10% of the taxable income
Over $11,950 but not over $45,550	$1,195 plus 15% of the excess over $11,950
Over $45,550 but not over $117,650	$6,235 plus 25% of the excess over $45,550
Over $117,650 but not over $190,550	$24,260 plus 28% of the excess over $117,650
Over $190,550 but not over $373,650	$44,672 plus 33% of the excess over $190,550
Over $373,650	$105,095 plus 35% of the excess over $373,650
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $16,750	10% of the taxable income
Over $16,750 but not over $68,000	$1,675 plus 15% of the excess over $16,750
Over $68,000 but not over $137,300	$9,362.50 plus 25% of the excess over $68,000
Over $137,300 but not over $209,250	$26,687.50 plus 28% of the excess over $137,300
Over $209,250 but not over $373,650	$46,833.50 plus 33% of the excess over $209,250
Over $373,650	$101,085.50 plus 35% of the excess over $373,650
Married Individuals Filing Separate Returns	
Not over $8,375	10% of the taxable income
Over $8,375 but not over $34,000	$837.50 plus 15% of the excess over $8,375
Over $34,000 but not over $68,650	$4,681.25 plus 25% of the excess over $34,000
Over $68,650 but not over $104,625	$13,343.75 plus 28% of the excess over $68,650
Over $104,625 but not over $186,825	$23,416.75 plus 33% of the excess over $104,625
Over $186,825	$50,542.75 plus 35% of the excess over $186,825

Table 8.–Tax Treatment of Long-Term Capital Gains of Individuals, 1913-2010

Year	Holding Period	Percentage of long-term capital gains includible in income	Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains
1913-21	n/a	n/a	n/a (highest rate on ordinary income ranged from 7% to 77%)
1922-33	2 years or less	n/a	n/a (highest rate on ordinary income ranged from 24% to 73%)
	Over 2 years	50	12.5%
1934-37	1 year or less	n/a	n/a (highest rate on ordinary income ranged from 63% to 79%)
	Over 1 year to 2 years	80	50.4% in 1934-35; 63.2% in 1936-37
	Over 2 years to 5 years	60	50.4% in 1934-35; 63.2% in 1936-37
	Over 5 years to 10 years	40	25.2% in 1934-35; 31.6% in 1936-37
	Over 10 years	30	25.2% in 1934-35; 31.6% in 1936-37
1938-41	18 months or less	n/a	n/a (highest rate on ordinary income ranged from 79% to 81.1%)
	Over 18 months to 2 years	66.87	30% of included gain, which was equivalent to a 20% rate
	Over 2 years	50	30% of included gain, which was equivalent to a 15% rate

Year	Holding Period	Percentage of long-term capital gains includible in income	Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains
1942-67	6 months or less	n/a	n/a (highest rate on ordinary income ranged from 70% to 94%)
	Over 6 months	50	25% (26% in 1952-53)
1968-71	6 months or less	n/a	n/a (highest rate on ordinary income ranged from 70% to 77%)
	Over 6 months	50	35%
1972-76	6 months or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 6 months	50	35%
1977	9 months or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 9 months	50	35%
1978	1 year or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 1 year	50 for gains realized before 11/1/78; 40 after 10/31/78	35% for gains realized before 11/1/78; 28% after 10/31/78
1979-80	1 year or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 1 year	40	28%
1981	1 year or less	n/a	n/a (highest rate on ordinary income: 69.125%)

Year	Holding Period	Percentage of long-term capital gains includible in income	Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains
	Over 1 year	40	28% for gains realized before 6/10/81; 20% after 6/9/81
1982-86	1 year or less (6 months or less for assets acquired after 6/22/84 and before 1/1/88)	n/a	n/a (highest rate on ordinary income: 50%)
	Over 1 year (over 6 months for assets acquired after 6/22/84 and before 1/1/88)	40	20%
1987-90	1 year or less (6 months or less for assets acquired after 6/22/84 and before 1/1/88)	n/a	n/a (highest rate on ordinary income: 38/5% in 1987; 33% thereafter (28% for individuals in the highest income group))
	Over 1 year (over 6 months for assets acquired after 6/22/84 and before 1/1/88)	100	28% in 1987; 33% thereafter (28% for individuals in the highest income group)
1991-92	1 year or less	100	n/a (highest rate on ordinary income: 31%)
	Over 1 year	n/a	28%
1993-97	1 year or less	100	n/a (highest rate on ordinary income: 39/6%)
	Over 1 year	n/a	28%
1997-1998	1 year or less	100	n/a (highest rate on ordinary income: 39.6%)
	Over 1 year	n/a	20% for gains realized after 5/7/97, 10%

Year	Holding Period	Percentage of long-term capital gains includible in income	Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains
			for gain income that would otherwise be taxed in the 15%-bracket. Maximum rate remains 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. A 50% exclusion for gains on sale of certain small business stock realized after 8/13/98 yields a maximum rate on qualifying stock at 14%.
1999-2000	1 year or less	100	n/a (highest rate on ordinary income: 39.6%)
	Over 1 year	n/a	20% (10% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.
2001	1 year or less	100	n/a (highest rate on ordinary income: 39.1%)
	Over 1 year	n/a	20% (10% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.

Year	Holding Period	Percentage of long-term capital gains includible in income	Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains
	Over 5 years	n/a	8% for gain on assets held for 5 or more years which otherwise would be taxed at 10% rate.
2002	1 year or less	100	n/a (highest rate on ordinary income: 38.6%)
	Over 1 year	n/a	20% (10% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.
	Over 5 years	n/a	8% for gain on assets held for 5 or more years which otherwise would be taxed at 10 percent rate.
2003-2007	1 year or less	100	n/a (highest rate on ordinary income: 35%)
	Over 1 year	n/a	15% (5% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.
2008-2010	1 year or less	100	n/a (highest rate on ordinary income: 35%)
	Over 1 year	n/a	15% (0% for gain income that would

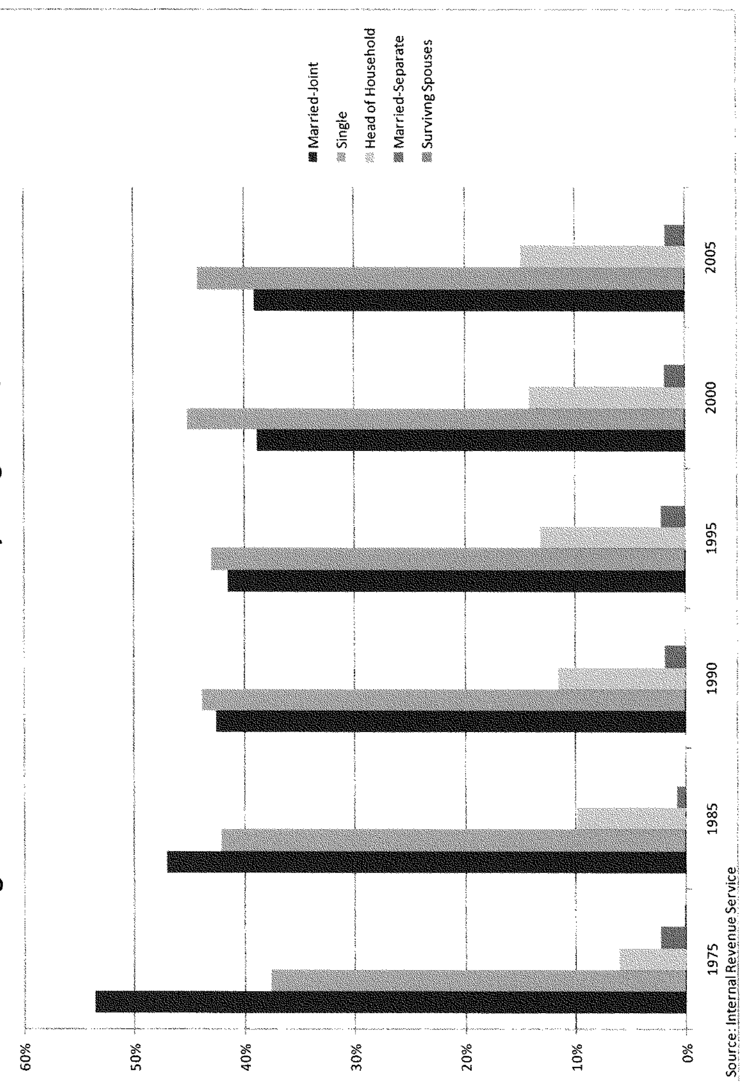
Year	Holding Period	Percentage of long-term capital gains includible in income	Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains
			otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.

Table 9.–Earned Income Credit: Number of Recipients and Amount of Credit, 1975-2008

Year	Number of receipient families (thousands)	Total amount of credit ($ millions)	Refunded portion of credit ($ millions)	Average credit per family
1975	6,215	1,250	900	201
1976	6,473	1,295	890	200
1977	5,627	1,227	880	200
1978	5,192	1,048	801	202
1979	7,135	2,052	1,395	288
1980	6,954	1,986	1,370	286
1981	6,717	1,912	1,278	285
1982	6,395	1,775	1,222	278
1983	7,368	1,795	1,289	224
1984	6,376	1,638	1,162	257
1985	7,432	2,088	1,499	281
1986	7,156	2,009	1,479	281
1987	8,738	3,391	2,930	450
1988	11,148	5,896	4,257	529
1989	11,696	6,595	4,636	564
1990	12,542	7,542	5,266	601
1991	13,665	11,105	8,183	813
1992	14,097	13,028	9,959	924
1993	15,117	15,537	12,028	1,028
1994	19,017	21,105	16,598	1,110
1995	19,334	25,956	20,829	1,342
1996	19,464	28,825	23,157	1,481
1997	19,391	30,389	24,396	1,567
1998	20,273	32,340	27,175	1,595
1999	19,259	31,901	27,604	1,656
2000	19,277	32,296	27,803	1,675
2001	19,593	33,376	29,043	1,704
2002	21,703	38,199	33,737	1,760
2003	22,024	38,657	24,012	1,755
2004	22,270	40,024	35,300	1,797
2005	22,752	42,410	37,465	1,864
2006	23,042	44,388	39,072	1,926
2007	24,584	48,540	42,508	1,974
2008	24,757	50,669	44,260	2,047

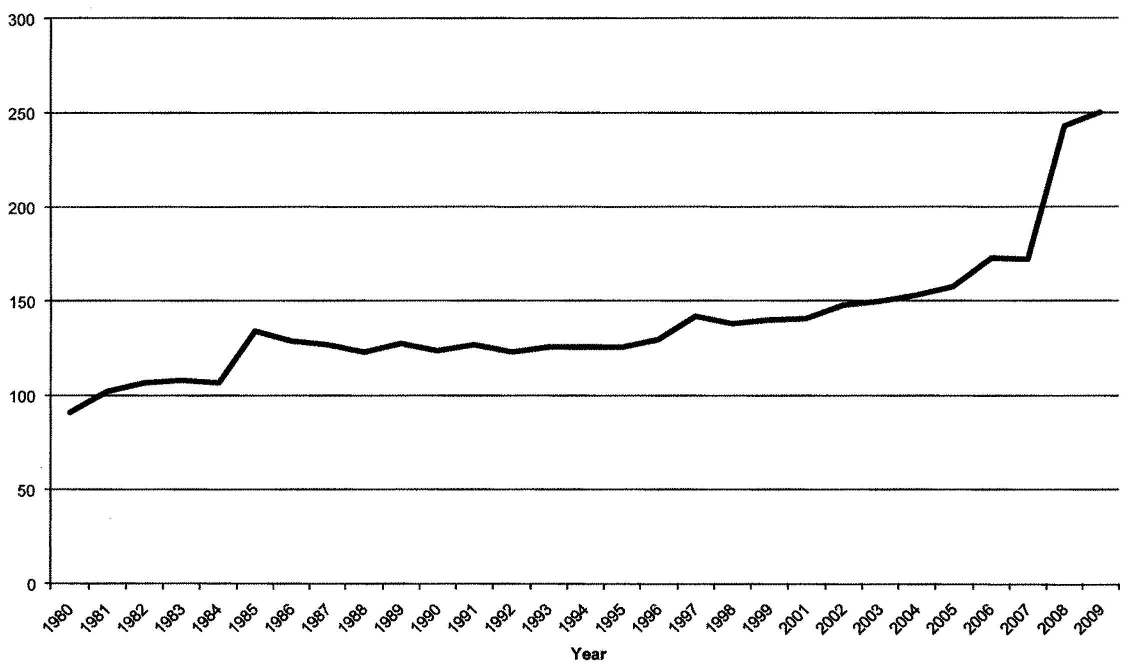
Source: Internal Revenue Service.

Figure 4.—Number of Returns by Filing Status, Percent of Total



Source: Internal Revenue Service

Figure 5.–Joint Committee on Taxation Count of Tax Expenditures, 1980-2009



Note: This chart shows the number of tax expenditures listed in the tables that appear in the Joint Committee on Taxation's annual pamphlet on tax expenditures. Certain methodological changes in how tax expenditures were defined and listed, notably expanded breakouts of certain tax provisions formerly listed as a single tax expenditure, account for the bulk of the substantial rise in listed tax expenditures from 2007 to 2008.

Table 10.–Aggregate Federal Receipts by Source, 1950-2009
[millions of dollars]

Fiscal Year	Individual Income Tax	Corporate Income Tax	Employment[1] Taxes	Excise Taxes	Estate and Gift Taxes	Other[2] Receipts	Total
1950	15,755	10,449	4,338	7,550	698	653	39,443
1951	21,616	14,101	5,674	8,648	708	870	51,616
1952	27,934	21,226	6,445	8,852	818	892	66,167
1953	29,816	21,238	6,820	9,877	881	976	69,608
1954	29,542	21,101	7,208	9,945	934	971	69,701
1955	28,747	17,861	7,862	9,131	924	926	65,451
1956	32,188	20,880	9,320	9,929	1,161	1,109	74,587
1957	35,620	21,167	9,997	10,534	1,365	1,307	79,990
1958	34,724	20,074	11,239	10,638	1,393	1,568	79,636
1959	36,719	17,309	11,722	10,578	1,333	1,588	79,249
1960	40,715	21,494	14,683	11,676	1,606	2,317	92,492
1961	41,338	20,954	16,439	11,860	1,896	1,900	94,388
1962	45,571	20,523	17,046	12,534	2,016	1,985	99,676
1963	47,588	21,579	19,804	13,194	2,167	2,228	106,560
1964	48,697	23,493	21,963	13,731	2,394	2,337	112,613
1965	48,792	25,461	22,242	14,570	2,716	3,037	116,817
1966	55,446	30,073	25,546	13,062	3,066	3,642	130,835
1967	61,526	33,971	32,619	13,719	2,978	4,009	148,822
1968	68,726	28,665	33,923	14,079	3,051	4,529	152,973
1969	87,249	36,678	39,015	15,222	3,491	5,227	186,882
1970	90,412	32,829	44,362	15,705	3,644	5,855	192,807
1971	86,230	26,785	47,325	16,614	3,735	6,450	187,139
1972	94,737	32,166	52,574	15,477	5,436	6,919	207,309
1973	103,246	36,153	63,115	16,260	4,917	7,109	230,799
1974	118,952	38,650	75,071	16,844	5,035	8,702	263,224
1975	122,386	40,621	84,534	16,551	4,611	10,387	279,090
1976	131,603	41,409	90,769	16,963	5,216	12,101	298,060
1977	157,626	54,892	106,485	17,548	7,327	11,681	355,559
1978	180,988	59,952	120,967	18,376	5,285	13,993	399,561
1979	217,841	65,677	138,939	18,745	5,411	16,690	463,302
1980	244,069	64,600	157,803	24,329	6,389	19,922	517,112
1981	285,917	61,137	182,720	40,839	6,787	21,872	599,272
1982	297,744	49,207	201,498	36,311	7,991	25,015	617,766
1983	288,938	37,022	208,994	35,300	6,053	24,256	600,562
1984	298,415	56,893	239,376	37,361	6,010	28,382	666,486
1985	334,531	61,331	265,163	35,992	6,422	30,598	734,088
1986	348,959	63,143	283,901	32,919	6,958	33,275	769,215
1987	392,557	83,926	303,318	32,457	7,493	34,536	854,353
1988	401,181	94,508	334,335	35,227	7,594	36,393	909,303
1989	445,690	103,291	359,416	34,386	8,745	39,576	991,190
1990	466,884	93,507	380,047	35,345	11,500	44,688	1,031,969
1991	467,827	98,086	396,016	42,402	11,138	39,527	1,055,041
1992	475,964	100,270	413,689	45,569	11,143	44,588	1,091,279
1993	509,680	117,520	428,300	48,057	12,577	38,206	1,154,401
1994	543,055	140,385	461,475	55,225	15,225	43,215	1,258,627
1995	590,244	157,004	484,473	57,484	14,763	47,833	1,351,830
1996	656,417	171,824	509,414	54,014	17,189	44,197	1,453,062
1997	737,466	182,293	539,371	56,924	19,845	43,341	1,579,292
1998	828,586	188,677	571,831	57,673	24,076	50,890	1,721,798
1999	879,480	184,680	611,833	70,414	27,782	53,270	1,827,454
2000	1,004,462	207,289	652,852	68,865	29,010	62,720	2,025,198
2001	994,339	151,075	693,967	66,232	28,400	57,129	1,991,142
2002	858,345	148,044	700,760	66,989	26,507	52,504	1,853,149
2003	793,699	131,778	712,978	67,524	21,959	54,383	1,782,321
2004	808,959	189,371	733,407	69,855	24,831	53,703	1,880,126
2005	927,222	278,282	794,125	73,094	24,764	56,138	2,153,625
2006	1,043,908	353,915	837,821	73,961	27,877	69,394	2,406,876
2007	1,163,472	370,243	869,607	65,069	26,044	73,566	2,568,001
2008	1,145,747	304,346	900,155	67,334	28,844	77,573	2,523,999
2009	915,308	138,229	890,917	62,483	23,482	74,576	2,104,995

[1] Employment taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad social security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of [1] customs duties and fees, and [2] deposits of earnings by the Federal Reserve system.

Source: Office of Management and Budget, *Historical Tables, Budget of the U.S. Government, Fiscal Year 2011, and JCT calculations.*

Table 11.–Federal Receipts by Source, As a Percentage of GDP, 1950-2009

Fiscal Year	Individual Income Tax	Corporate Tax	Employment[1] Taxes	Excise Taxes	Estate and Gift Taxes	Other[2] Receipts	Total
1950	5.8	3.8	1.6	2.8	0.3	0.2	14.4
1951	6.8	4.4	1.8	2.7	0.2	0.3	16.1
1952	8.0	6.1	1.8	2.5	0.2	0.3	19.0
1953	8.0	5.7	1.8	2.7	0.2	0.3	18.7
1954	7.8	5.6	1.9	2.6	0.2	0.3	18.5
1955	7.3	4.5	2.0	2.3	0.2	0.2	16.5
1956	7.5	4.9	2.2	2.3	0.3	0.3	17.5
1957	7.9	4.7	2.2	2.3	0.3	0.3	17.7
1958	7.5	4.4	2.4	2.3	0.3	0.3	17.3
1959	7.5	3.5	2.4	2.2	0.3	0.3	16.2
1960	7.8	4.1	2.8	2.3	0.3	0.4	17.8
1961	7.8	4.0	3.1	2.2	0.4	0.4	17.8
1962	8.0	3.6	3.0	2.2	0.4	0.3	17.6
1963	7.9	3.6	3.3	2.2	0.4	0.4	17.8
1964	7.6	3.7	3.4	2.1	0.4	0.4	17.6
1965	7.1	3.7	3.2	2.1	0.4	0.4	17.0
1966	7.3	4.0	3.4	1.7	0.4	0.5	17.3
1967	7.6	4.2	4.0	1.7	0.4	0.5	18.4
1968	7.9	3.3	3.9	1.6	0.4	0.5	17.6
1969	9.2	3.9	4.1	1.6	0.4	0.6	19.7
1970	8.9	3.2	4.4	1.6	0.4	0.6	19.0
1971	8.0	2.5	4.4	1.5	0.3	0.6	17.3
1972	8.1	2.7	4.5	1.3	0.5	0.6	17.6
1973	7.9	2.8	4.8	1.2	0.4	0.5	17.6
1974	8.3	2.7	5.2	1.2	0.4	0.6	18.3
1975	7.8	2.6	5.4	1.1	0.3	0.7	17.9
1976	7.6	2.4	5.2	1.0	0.3	0.7	17.1
1977	8.0	2.8	5.4	0.9	0.4	0.6	18.0
1978	8.2	2.7	5.5	0.8	0.2	0.6	18.0
1979	8.7	2.6	5.6	0.7	0.2	0.7	18.5
1980	9.0	2.4	5.8	0.9	0.2	0.7	19.0
1981	9.4	2.0	6.0	1.3	0.2	0.7	19.6
1982	9.2	1.5	6.3	1.1	0.2	0.8	19.2
1983	8.4	1.1	6.1	1.0	0.2	0.7	17.5
1984	7.8	1.5	6.2	1.0	0.2	0.7	17.3
1985	8.1	1.5	6.4	0.9	0.2	0.7	17.7
1986	7.9	1.4	6.4	0.7	0.2	0.8	17.5
1987	8.4	1.8	6.5	0.7	0.2	0.7	18.4
1988	8.0	1.9	6.7	0.7	0.2	0.7	18.2
1989	8.3	1.9	6.7	0.6	0.2	0.7	18.4
1990	8.1	1.6	6.6	0.6	0.2	0.8	18.0
1991	7.9	1.7	6.7	0.7	0.2	0.7	17.8
1992	7.6	1.6	6.6	0.7	0.2	0.7	17.5
1993	7.7	1.8	6.5	0.7	0.2	0.6	17.5
1994	7.8	2.0	6.6	0.8	0.2	0.6	18.0
1995	8.0	2.1	6.6	0.8	0.2	0.7	18.4
1996	8.5	2.2	6.6	0.7	0.2	0.6	18.8
1997	9.0	2.2	6.6	0.7	0.2	0.5	19.2
1998	9.6	2.2	6.6	0.7	0.3	0.6	19.9
1999	9.6	2.0	6.6	0.8	0.3	0.6	19.8
2000	10.2	2.1	6.6	0.7	0.3	0.6	20.6
2001	9.7	1.5	6.8	0.6	0.3	0.6	19.5
2002	8.1	1.4	6.6	0.6	0.3	0.5	17.6
2003	7.2	1.2	6.5	0.6	0.2	0.5	16.2
2004	6.9	1.6	6.3	0.6	0.2	0.5	16.1
2005	7.5	2.2	6.4	0.6	0.2	0.5	17.3
2006	7.9	2.7	6.3	0.6	0.2	0.5	18.2
2007	8.4	2.7	6.3	0.5	0.2	0.5	18.5
2008	7.9	2.1	6.2	0.5	0.2	0.5	17.5
2009	6.4	1.0	6.3	0.4	0.2	0.5	14.8
1950-2009 Avg.	8.0	2.8	5.0	1.3	0.3	0.5	17.9

[1] Employment taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad Social Security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of (1) customs duties and fees, and (2) deposits of earnings by the Federal Reserve system.

Source: Office of Management and Budget, *Historical Tables, Budget of the U.S. Government, Fiscal Year 2011;* Economic Report of the President, 2010, Table B-78 for fiscal year GDP Figures.

Table 12.–Federal Receipts by Source, As a Percentage of Total Revenues, 1950-2009

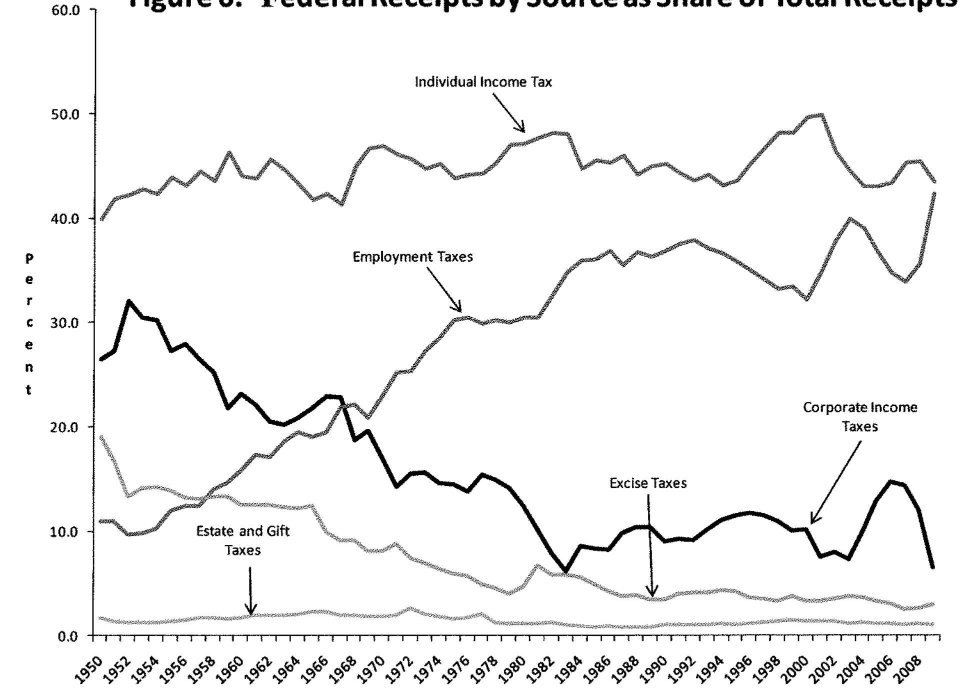
Fiscal Year	Individual Income Tax	Corporate Tax	Employment[1] Taxes	Excise Taxes	Estate and Gift Taxes	Other[2] Receipts
1950	39.9	26.5	11.0	19.1	1.8	1.7
1951	41.9	27.3	11.0	16.8	1.4	1.7
1952	42.2	32.1	9.7	13.4	1.2	1.3
1953	42.8	30.5	9.8	14.2	1.3	1.4
1954	42.4	30.3	10.3	14.3	1.3	1.4
1955	43.9	27.3	12.0	14.0	1.4	1.4
1956	43.2	28.0	12.5	13.3	1.6	1.5
1957	44.5	26.5	12.5	13.2	1.7	1.6
1958	43.6	25.2	14.1	13.4	1.7	2.0
1959	46.3	21.8	14.8	13.3	1.7	2.0
1960	44.0	23.2	15.9	12.6	1.7	2.5
1961	43.8	22.2	17.4	12.6	2.0	2.0
1962	45.7	20.6	17.1	12.6	2.0	2.0
1963	44.7	20.3	18.6	12.4	2.0	2.1
1964	43.2	20.9	19.5	12.2	2.1	2.1
1965	41.8	21.8	19.0	12.5	2.3	2.6
1966	42.4	23.0	19.5	10.0	2.3	2.8
1967	41.3	22.8	21.9	9.2	2.0	2.7
1968	44.9	18.7	22.2	9.2	2.0	3.0
1969	46.7	19.6	20.9	8.1	1.9	2.8
1970	46.9	17.0	23.0	8.1	1.9	3.0
1971	46.1	14.3	25.3	8.9	2.0	3.4
1972	45.7	15.5	25.4	7.5	2.6	3.3
1973	44.7	15.7	27.3	7.0	2.1	3.1
1974	45.2	14.7	28.5	6.4	1.9	3.3
1975	43.9	14.6	30.3	5.9	1.7	3.7
1976	44.2	13.9	30.5	5.7	1.7	4.1
1977	44.3	15.4	29.9	4.9	2.1	3.3
1978	45.3	15.0	30.3	4.6	1.3	3.5
1979	47.0	14.2	30.0	4.0	1.2	3.6
1980	47.2	12.5	30.5	4.7	1.2	3.9
1981	47.7	10.2	30.5	6.8	1.1	3.6
1982	48.2	8.0	32.6	5.9	1.3	4.0
1983	48.1	6.2	34.8	5.9	1.0	4.0
1984	44.8	8.5	35.9	5.6	0.9	4.3
1985	45.6	8.4	36.1	4.9	0.9	4.2
1986	45.4	8.2	36.9	4.3	0.9	4.3
1987	46.0	9.8	35.5	3.8	0.9	4.0
1988	44.1	10.4	36.8	3.9	0.8	4.0
1989	45.0	10.4	36.3	3.5	0.9	4.0
1990	45.2	9.1	36.8	3.4	1.1	4.3
1991	44.3	9.3	37.5	4.0	1.1	3.7
1992	43.6	9.2	37.9	4.2	1.0	4.1
1993	44.2	10.2	37.1	4.2	1.1	3.3
1994	43.1	11.2	36.7	4.4	1.2	3.4
1995	43.7	11.6	35.8	4.3	1.1	3.5
1996	45.2	11.8	35.1	3.7	1.2	3.0
1997	46.7	11.5	34.2	3.6	1.3	2.7
1998	48.1	11.0	33.2	3.3	1.4	3.0
1999	48.1	10.1	33.5	3.9	1.5	2.9
2000	49.6	10.2	32.2	3.4	1.4	3.1
2001	49.9	7.6	34.9	3.3	1.4	2.9
2002	46.3	8.0	37.8	3.6	1.4	2.8
2003	44.5	7.4	40.0	3.8	1.2	3.1
2004	43.0	10.1	39.0	3.7	1.3	2.9
2005	43.1	12.9	36.9	3.4	1.1	2.6
2006	43.4	14.7	34.8	3.1	1.2	2.9
2007	45.3	14.4	33.9	2.5	1.0	2.9
2008	45.4	12.1	35.7	2.7	1.1	3.1
2009	43.5	6.6	42.3	3.0	1.1	3.5
1950-2009 Avg.	44.8	15.7	27.7	7.3	1.5	3.0

[1] Employment taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad Social Security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of (1) customs duties and fees, and (2) deposits of earnings by the Federal Reserve system.

Source: Office of Management and Budget, *Historical Tables, Budget of the U.S. Government, Fiscal Year 2011.*

Figure 6.–Federal Receipts by Source as Share of Total Receipts



Source: Office of Management and Budget; Historical Tables, Budget of the U.S. Government, Fiscal Year 2011, and Joint Committee on Taxation Calculations.

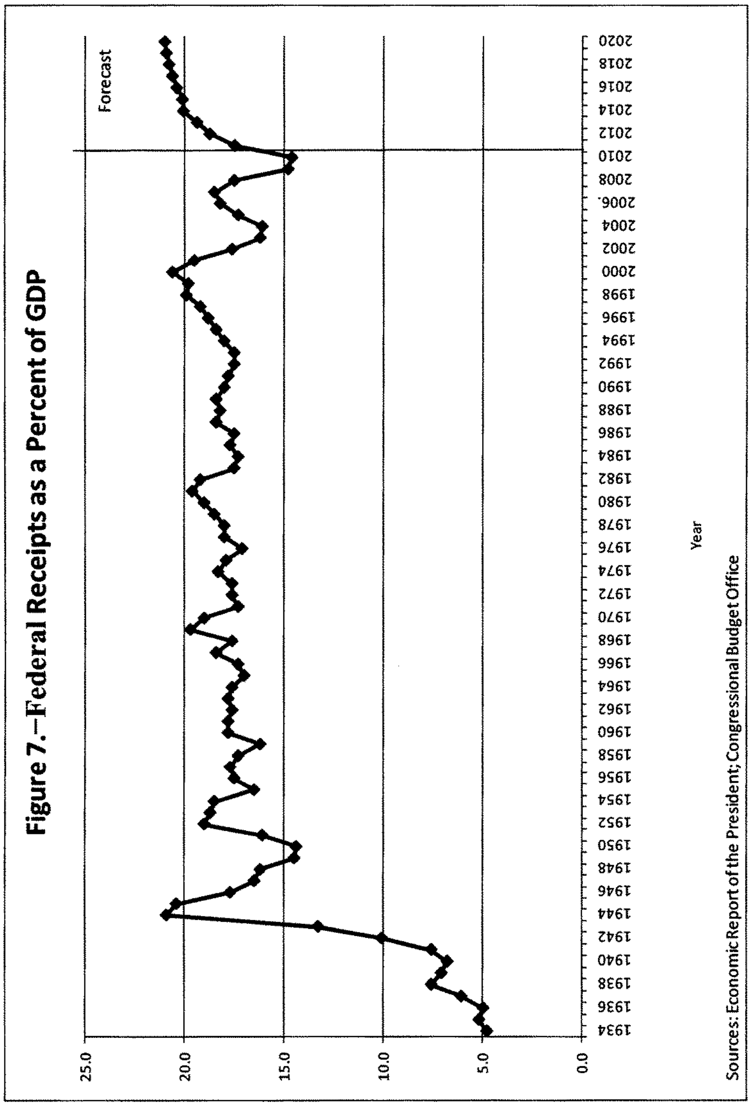


Figure 7.–Federal Receipts as a Percent of GDP
Forecast
25.0
20.0
15.0
10.0
5.0
0.0
1934
1936
1938
1940
1942
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1948
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1952
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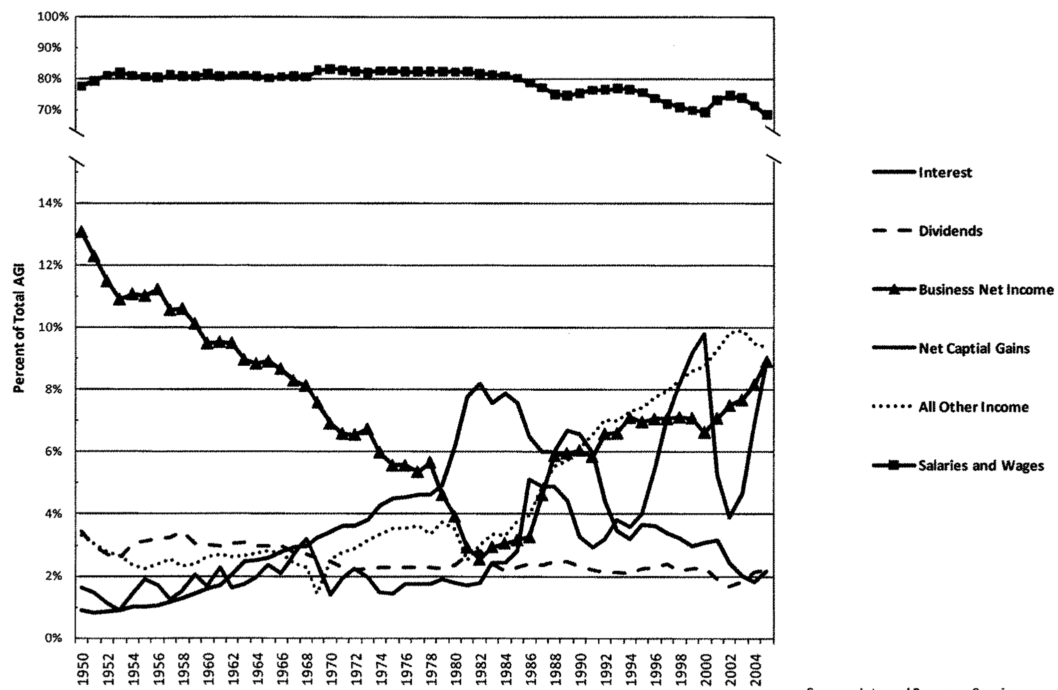
2016
2018
2020
Year
Sources: Economic Report of the President; Congressional Budget Office

Figure 8.—Components of AGI as Percentage of Total (Nationwide Aggregates), 1950-2005



Source: Internal Revenue Service

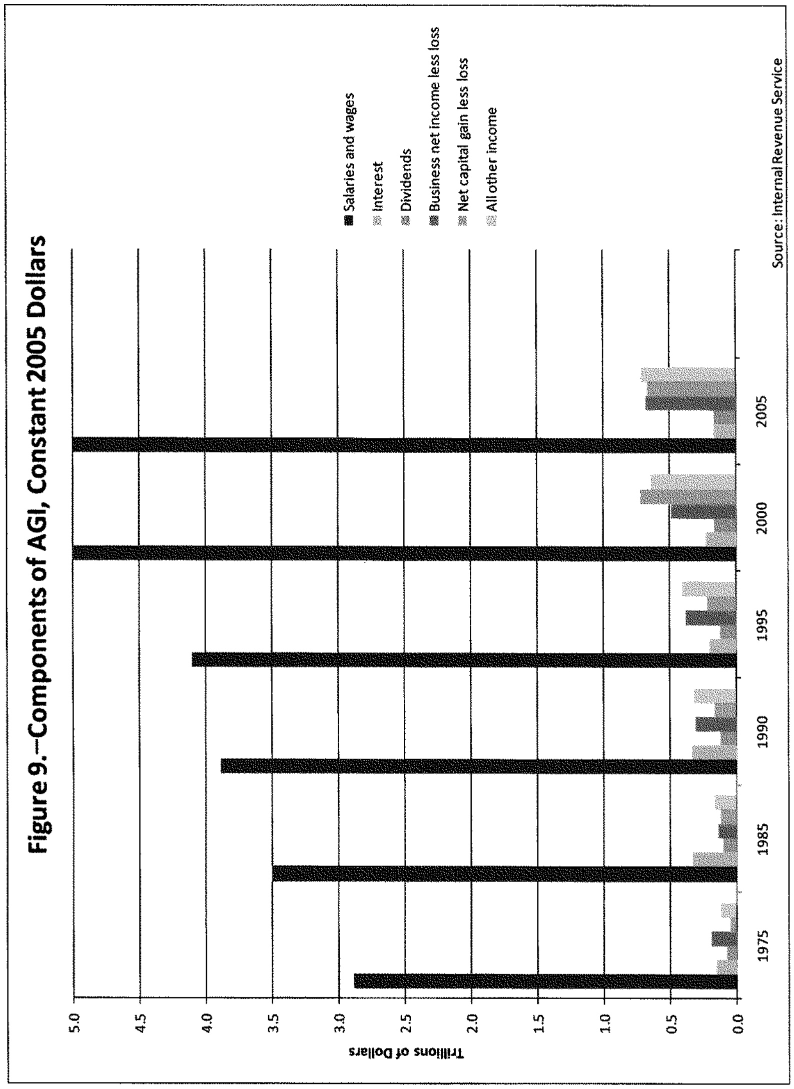


Figure 9.--Components of AGI, Constant 2005 Dollars

Senate Finance Committee Hearing
"Tax Reform: Historical Trends in Income and Revenue"
December 2, 2010
Responses to Questions for Mr. Thomas Barthold

Questions from Senator Grassley

1. The evidence shows that the growth for US corporations is mostly in the global economy, outside the US, not inside the US. So, this undoubtedly puts more pressure on making sure we get the international tax rules right.

   a. Isn't it the trend amongst the developed countries to go towards a territorial tax system, even though the US continues to be on worldwide tax system?

   b. Do you believe this may put US corporations at a competitive disadvantage in the global economy when competing with a company based in a country with a territorial system?

   c. A frequent criticism of a territorial system is that it would put greater pressure on the transfer pricing rules than already exists. Arguably, the transfer pricing rules do not work very well already, and such a change could exacerbate the problem. How have other countries that have transitioned to a territorial regime addressed concerns about transfer pricing?

   Answer:

   a. Developed countries that have changed their tax systems in recent years generally have switched from worldwide tax systems to territorial tax systems. For example, in 2009 Japan and the United Kingdom adopted territorial tax systems. With those changes, 25 of the 30 countries that made up the Organisation for Economic Co-operation and Development (the "OECD") at the end of 2009 had territorial tax systems. The five OECD countries with worldwide tax systems at that time were the United States, Ireland, Korea, Mexico, and Poland. In 2010, however, four additional countries (Chile, Estonia, Israel, and Slovenia) joined the OECD, and each has a worldwide tax system. Israel, it bears noting, adopted its worldwide tax system in 2003, moving away from a territorial tax system.

   b. The tax system under which a multinational corporation operates may be one of several factors, including, *inter alia*, labor costs, product quality, and the regulatory environment, that affects the competitiveness of a particular corporation. In considering the impact of the U.S. worldwide tax system on the competitiveness of a U.S. multinational corporation vis-à-vis a multinational corporation resident in a country with a territorial tax system, certain features of the U.S. system are of particular significance. U.S. multinational corporations are able to defer U.S. taxation of their active foreign earnings, which helps equalize the rate of tax effectively imposed on the earnings of their foreign affiliates with that imposed on the subsidiaries of their foreign multinational competitors. In addition, U.S. multinational corporations that repatriate high-tax earnings may, in certain circumstances, be able to use excess foreign tax credits arising from these repatriations to offset the U.S. tax on lower-tax items of foreign-source income. Nevertheless, the potential for taxation under the U.S. international tax system by reason of either repatriation or application of the highly complex anti-deferral rules may force U.S. multinational corporations to contend with a greater degree of complexity, and to engage in a greater degree of tax-distorted business planning, than many of their foreign competitors resident in countries with territorial tax systems.

As a result of the features of the U.S. international tax system noted above, some argue that U.S. multinational corporations may actually achieve more favorable tax results than their foreign competitors located in countries with territorial tax systems. Others argue that features of the U.S. international tax system such as those noted above, at best allow U.S. multinational corporations to compete without the U.S. international tax system as an impediment, and, at worst, still leave U.S. multinational corporations at a competitive disadvantage. Additional discussion of this issue may be found in Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-2-05), pages 186-97, January 27, 2005, and Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposals* (JCS-2-10), pages 218-22, August 16, 2010.

c. The tax laws of the United States and most of our major trading partners include transfer pricing rules that are generally consistent with guidelines developed by the Organisation for Economic Co-operation and Development, of which the United States and most of our major trading partners are members. See Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010). These principles generally do not depend in their application on whether the country adopting them employs a worldwide or territorial tax system. Thus, when a country transitions from a worldwide to a territorial tax system, significant changes in that country's transfer pricing rules are not generally adopted.

Transfer pricing is a challenging issue for all countries, regardless of whether they have a worldwide tax system like the United States or a territorial tax system. Under either type of system, taxpayers have incentives to utilize transfer pricing to minimize their overall tax burdens. It may be argued that any tax system other than a pure worldwide system–one in which every dollar a taxpayer earns, regardless of source, is currently taxed–may present opportunities for taxpayers to use transfer pricing to minimize their tax liabilities. No country has adopted such a system.

Additional information about these issues may be found in our recent publication, Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, which includes a background discussion of business restructuring, a description of present U.S. tax law, including transfer pricing rules, and six case studies of U.S.-based multinational corporations and how the business structures of those corporations interact with the U.S. tax laws. The case studies presented focus on U.S-based multinational corporations, but foreign multinational corporations may use structures similar to those described to obtain business and tax benefits even when located in jurisdictions that have territorial systems.

2. We sometimes hear that the Social Security tax is a regressive tax. So, I would like to explore that a bit with a few questions:

    a. Isn't it the case that the benefit payment formula for Social Security is quite progressive, not regressive?

    b. Also, if say, there were a law mandating that everybody put $1000 into an Individual Retirement Account, would that be a regressive tax? While it would be mandatory, like a tax, given that it would not even be going to the government, and given that it would be for the contributor's own benefit, it doesn't even seem like it is a tax at all. But this mandatory Individual Retirement Account idea would be a lot more regressive than our current Social Security system, right? That is, given that one's Social Security benefits are tied to one's payments into the Social Security system, just as is the case with an IRA contribution, do you believe it is arguable that the Social Security tax should not be considered a regressive tax?

Answer:

While I am not an expert on the benefit side of the Social Security system, many have noted that while the payroll tax is regressive (because of the cap on taxable earnings), the overall system is progressive because of the benefit formula. Others have noted that the progressivity of the system is diminished when spouse and survivor benefits are considered.[1] Still others have observed that further adjustments, such as taking into account the longer life expectancy of higher-income individuals, render the system no longer progressive, and even regressive under higher discount rate assumptions, which give greater weight to the earlier-but-regressive tax and lesser weight to the later-but-progressive benefit structure.[2] Thus, there is some debate as to whether the full social security system is, on balance, progressive.

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[1] See Alan Gustman and Thomas Steinmeier, "How effective is redistribution under the social security benefit formula?" *Journal of Public Economics*, Volume 82, Issue 1, October 2001.

[2] See Julia Coronado, Don Fullerton and Thomas Glass, "The Progressivity of Social Security," National Bureau of Economic Research Working Paper #7520, Cambridge, MA (2000).

With respect to your question concerning the mandatory IRA, it is not obvious, as you note, whether such a requirement would be considered a tax. Regardless of whether such a hypothetical requirement is a tax, your hypothetical mandatory IRA system does not redistribute income.[3] Thus, depending on one's views of the validity of the studies cited above, your mandatory IRA system is either more, or less, progressive than the current social security system.

3. In Keynesian terms, stimulus is usually regarded as i) temporary, and ii) aimed at getting money to people who will most likely spend it, thus stimulating demand. That is, Keynesian economics can be thought of as "demand-side" economics. "Supply-side" economics, on the other hand, is targeted at creating incentives to create additional supply. We usually think of supply-side economics in terms of creating long-term incentives to save and invest. Accordingly, it would seem that demand-side or Keynesian tax policy would be oriented to getting money to people in lower-income brackets, and only for a temporary period. On the other hand, supply-side economics would suggest that tax-cuts should be aimed at getting higher-income tax brackets reduced, and for a permanent period of time. Assuming that there is some legitimacy to both Keynesian and supply-side economics, and that both have something useful to say about tax policy, wouldn't this suggest that if any tax-cuts are to be temporary, it should be the lower-income ones, and if any are to be permanent, it should be the upper-income ones?

<u>**Answer:**</u>

For the purpose of short-run economic stimulus, it is appropriate that tax cuts be temporary, and that they be focused on taxpayers who are most likely to spend out of their higher after-tax income. In general, lower income households spend a larger share of changes in after-tax income than higher income households.

Long-run growth is determined by the amount of physical capital, human capital, and labor that taxpayers are willing to devote to production. Taxes influence this decision through their effects on after-tax rates of return on these resources. Thus, for long-run investment decisions, which depend on the after-tax rate of return, it is important that tax rates be predictable throughout the income distribution. The return on physical capital investment depends on how much human capital and labor will be supplied, which also depends in turn on whether tax rates are stable throughout the income distribution. For instance, suppose a taxpayer is deciding whether to invest in an MRI machine. The return on that machine will depend not only on the tax rate on the income it produces, but also on the availability of skilled technicians at reasonable (and predictable) wage rates. However, it takes education to become an MRI technician, and if tax rates in their income

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[3] As your proposal has no details, I am assuming that named beneficiaries or heirs, rather than the government, retain any funds in the IRA at the time of death of the owner. For these purposes, I do not consider any distribution of IRA benefits to beneficiaries to constitute redistribution of income.

range are high and unpredictable, then people might choose not to invest in that education. And even if a person has trained to become an MRI technician, if tax rates are unexpectedly high when they are deciding whether to work or not, they may conclude that their after tax income is not enough to make it pay to work. The decreased supply of trained MRI technicians means that labor costs will be higher, so the return on the MRI investment will be unexpectedly low. Similar examples apply throughout the income distribution – our economy depends on unskilled labor and on skilled labor at every income level. Thus, it is important for capital formation that tax rates be stable and predictable throughout the income distribution.

Another factor that affects return on investment is the cost of capital, which includes borrowing costs. If federal deficits continue to be large, then the federal government's presence in the borrowing markets would be expected to push up interest rates. Thus, setting spending policy and tax policy in a stable and predictable fashion that reduces forecast deficits but keeps tax rates as low as possible throughout the income distribution will help improve the expected after-tax return on investment, and encourage capital formation, both physical and human capital. Most tax reform proposals are focused on lowering rates throughout the income distribution, while paying for the lower rates with reduced deductions.

We would be happy to discuss these issues with you further at your convenience.

Questions from Senator Bill Nelson

1. In a report released yesterday, Goldman Sachs raised its estimates for economic growth in 2011 and 2012, but suggested the greatest risk to the economy remains the housing market. The report states: "On the downside, the risk that worries us most is the potential for a significant renewed drop in home prices to trigger another round of consumer retrenchment. We have been estimating that prices would drop only 2½%-3½% over the next couple of years, but as the passage of time allows us to pin down the effects of the homebuyer tax credit more precisely, we now estimate that prices could drop 5% or a bit more over the next year." Just this week, I proposed a new extension of the homebuyer credit. In your view, what effect would renewing the homebuyer tax credit have on the housing market and the economy?

   Answer:

   While data are not yet available to assess fully the impact of the most recent homebuyer tax credit, preliminary analysis suggests that falling prices and mortgage rates may have had a more significant effect on the cost of becoming a homeowner than the tax credit.[1]

   Research on a similar longer-standing provision for the District of Columbia may also be relevant. Research suggests that the credit increased housing prices in the District and increased activity in the construction sector, but had a negligible effect on the D.C. economy as a whole, with gains in the construction sector coming at the expense of other sectors in the D.C. economy.[2]

   If the proposed extension of national homebuyer credit were temporary, purchase activity may be accelerated in time into the period in which the credit were available, potentially leading to a drop off in activity after the credit expires. Preliminary data suggest this may have been the case with the most recent expiration of the homebuyer credit.[3]

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[1] A preliminary analysis was undertaken by the Congressional Research Service. Mark P. Keightley, "An Economic Analysis of the Homebuyer Tax Credit" (R40955), Congressional Research Service, December 1, 2009.

[2] Zhong Yi Tong, "Washington, D.C.'s First-Time Homebuyer Tax Credit: An Assessment of the Program," *Fannie Mae Foundation Special Report Series*, April 2005, available at SSRN: http://ssrn.com/abstract=983118.

[3] For example, the National Association of Realtors Pending Home Sales Index fell from 110.9 in April 2010, the month in which purchase contracts needed to be signed, to 77.6 in May 2010. National Association of

2. American consumers are deleveraging, paying down debt, and spending less. In contrast, domestic consumption in many developing countries is on the rise. As a result, our ability to compete in foreign markets is expected to play a major role in our future growth. In your view, do our current international tax rules contribute to export-driven job creation in the United States? Or do the international tax rules discourage domestic job growth?

   Answer:

   Empirical research has not produced definitive conclusions about the effect of U.S. international tax rules on U.S. employment. Some argue that U.S. international tax rules create an incentive for outbound investment. Some evidence suggests that foreign production displaces certain types of domestic production. Other evidence suggests that foreign direct investment may be complementary to, and not a substitute for, domestic investment. The Joint Committee staff has reviewed some of this literature and provided additional discussion of this issue in two recent staff publications, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposals* (JCS-2-10), pages 215-18, August 16, 2010, and Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), page 4, July 20, 2010.

3. Since its enactment, a basic foundation of the income tax has been the "ability to pay" principle. Those that can afford to bear a greater share of the tax burden do so. Over the last 30-40 years, income and wealth has been increasingly concentrated at the top end of the income scale, with a hollowing out of the middle class. Presumably, the tax burden should have shifted along with this change in income and wealth distribution. Has this occurred? Has the tax burden shifted at the same rate that income and wealth has become concentrated?

   Answer:

   As the share of income reported by the top income groups has increased over time, their share of taxes paid has also increased. Published IRS data[4] show the distribution of adjusted gross income (AGI) and taxes paid for different percentiles of the income distribution. In 1990, the top ten percent of the income distribution reported 38.8 percent of total AGI and paid 55.4 percent of total federal income tax. In 2007, the top ten percent of the income distribution reported 48.7 percent of total AGI and paid 71.2 percent of total federal income tax. As a cautionary note, comparisons such as the one

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Realtors, "Pending Home Sales Drop as Expected," Press Release, July 1, 2010, available at http://www.realtor.org/press_room/news_releases/2010/07/phs_drop.

[4] See http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96679,00.html#_grp1.

above are affected by changes in the definition of AGI over time (such as whether all or only a portion of capital gains are included in AGI). And of course the share of taxes paid by a given income group over time will be affected by changes in the tax laws that affect the progressivity of the federal income tax system.

4. At the end of the day, compared to our major trading partners, is the United States a low-tax nation or a high-tax nation? I'm not asking just about income taxes. I'm not even talking just about federal taxes. With respect to the *total tax burden* – federal, state, and local, how does America come out relative to other countries?

Answer:

According to the most recent comprehensive data[5] available from the Organization for Economic Coorperation and Development (OECD), in 2008 the OECD member country average receipts for all levels of government as a percentage of GDP was 34.8 percent. By comparison, the United States was 26.1 percent. Luxembourg had the lowest figure for receipts as a percent of GDP at 21 percent, while Denmark had the highest at 48.2 percent.

For 2009, the comparable figure for United States was 24.0 percent. A comparable figure for all OECD member countries is not yet available for 2009.

5. For the typical middle-class family, the last 10 years can be summed up with the following: stagnant or declining real wages; rising health insurance premiums; higher food, energy, and transportation costs; increasingly unaffordable college tuition; decimated 401(k) retirement accounts; underwater mortgages; oppressive and unsustainable credit card debts; and serious doubts that their children will have a higher standard of living than they did. Is there any solid evidence you can cite that demonstrates these struggling middle class families benefited, even on a trickle-down basis, from the 2001 tax cuts that applied to those making more than $1 million a year?

Answer:

We are not aware of any solid, empirical evidence that directly addresses the question of whether the portion of the 2001 and 2003 tax cuts that affected taxpayers with incomes of $1 million and up benefitted middle-class taxpayers. Even an empirical analysis of the more general question of the economic effects of those tax cuts is very difficult to perform. It is not known how the economy would have performed in the absence of these tax cuts, so one cannot directly measure their effect. Comparisons with other time periods that did not have these tax cuts are complicated by the fact that there are inevitably other economic differences between the time periods, for example tax, spending, or monetary policy that differed in significant ways from the period between

[5] See http://stats.oecd.org.

2000 and 2010. And there are other significant economic differences, such as changes to the composition of the labor force, technological changes such as the internet, or international influences such as changes in oil prices. One might try to compare groups that are affected by a tax policy with those who are not affected, but the 2001 and 2003 tax cuts affected nearly all taxpayers. To date, studies on the overall economic effects of the 2001 and 2003 tax cuts have not provided definitive results. It is even more difficult to separate out the effects of the tax cuts on middle income taxpayers, or to identify what portion of the that effect comes from the portion of the tax cuts that went to those who earn more than $1 million per year.

Macroeconomic modeling may provide some evidence relevant to the overall question of the economic effects of the tax cuts, though not without uncertainty. Macroeconomic models generally attempt to be consistent with economic theory and with empirical evidence on economic behavior. However, the more precise the question that is asked of macroeconomic models, the harder it is for the models to answer the question with certainty, since the model is typically constructed to provide general results and an effort to re-specify the model would still be limited by available empirical and theoretical evidence.

Questions from Senator Hatch

1. All of your testimonies are excellent and filled with useful information in terms of how our tax system operates. However, I saw very little in there about the research tax credit. Maybe it is because we have no research credit at the present time. One of my biggest concerns from a competitiveness standpoint is that we as a nation are at risk of losing a great deal of the R&D that is performed in this country because other nations have enacted very generous research tax incentives in an attempt to lure away research from our shores. Do you agree with me that a U.S. temporary research tax credit that is on again and off again with no certainty about its future is far less effective in competing against foreign research tax incentives than a strong permanent research incentive?

   Answer:

   Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is regularly renewed.

2. In talking about the progressivity of our federal tax system, which I believe all of you did in your testimonies, you indicate that the federal tax system overall is progressive, but that the income tax component is much more progressive. In other words, the payroll tax and the excise tax components are not nearly as progressive and may even be regressive. My question is this: when talking about the payroll tax component, are you considering the fact that the Social Security system itself, through its benefit structure, is quite progressive in that lower-income workers get back a larger share of their contributions than do higher-income workers? When taking into account the benefits of Social

Security, wouldn't the overall tax system be even more progressive than what you are indicating?

Answer:

While I am not an expert on the benefit side of the Social Security system, taking into account Social Security benefits may indeed impact one's judgment of the system's progressivity. Considered alone, the payroll tax is regressive, due to the cap on taxable earnings. However, many have noted that while the payroll tax is regressive, the overall system is progressive when one takes into account the benefit formula.[6] Others, however, have noted that the progressivity of the system is diminished when spouse and survivor benefits are considered.[7] Still others have observed that further adjustments, such as taking into account the longer life expectancy of higher-income individuals, render the system no longer progressive, and even regressive under higher discount rate assumptions, which give greater weight to the earlier-but-regressive tax and lesser weight to the later-but-progressive benefit structure.[8] Thus, there is some debate as to whether the full social security system is, on balance, progressive. Nonetheless, consideration of only the tax side, and not the spending side, of federal fiscal policy can give a misleading picture of the overall progressivity of federal policies.

3. Your testimonies discussed the distribution of income and of the tax burden by quintiles of income earners. For example, Dr. Mazur indicated that the share of pre-tax income going to those in the lowest quintile fell from 5.7 percent to 4 percent between 1979 and 2007. I have two questions about this. First, does the pre-tax income of those in this lowest quintile include the various forms of federal, state, and local government assistance they may be receiving? Second, if we were to factor in the tax benefits from the Earned Income Credit and other forms of refundable tax credits, would the data indicate that those in this lowest quintile are doing much better than these pre-tax numbers show?

Answer:

Because this question addresses the testimonies of Dr. Mazur and Dr. Elmendorf, I will defer to them for a response.

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[6] See, for example, Congressional Budget Office, "Is Social Security Progressive?" December 15, 2006.

[7] See Alan Gustman and Thomas Steinmeier, "How effective is redistribution under the social security benefit formula?" *Journal of Public Economics*, Volume 82, Issue 1, October 2001.

[8] See Julia Coronado, Don Fullerton and Thomas Glass, "The Progressivity of Social Security," National Bureau of Economic Research Working Paper #7520, Cambridge, MA (2000).

4. CBO has released estimates of revenues under current law and under the assumption that the expiring tax relief provisions from 2001 and 2003 are extended in various scenarios. For example, the projection on page 7 of Dr. Elmendorf's testimony (Exhibit 3) indicates that revenue as a percentage of GDP would drop in 2012 by 1.7 percent from current law if we extend all the tax relief provisions on a permanent basis. However, Dr. Elmendorf's testimony includes this caveat: "These estimates do not incorporate the impact that the policy options would have on economic activity." This is a pretty big caveat, is it not?

   For example, I read yesterday that a number of economists are warning that if Congress fails to extend the tax relief provisions, there is a very good chance that the economy will go back into recession next year. My question is this: If we do take into account the impact of the policy options on economic activity, wouldn't the effect on revenue loss of extending the tax relief provisions be much less than what CBO is projecting?

   Answer:

   Taking into account the effects on the overall economy of temporarily extending tax rate cuts in the recently-enacted Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 could potentially reduce the estimated revenue loss somewhat. JCT staff has done a preliminary analysis of the effects of the two year extension. We find that relative to present law, the extension would increase the size of the economy, as measured by the percent change in real GDP, by an amount between 0.6 percent and 1.7 percent during the two years of the policy period, primarily due to extra demand that would be generated by the tax rate reductions. This growth would result in a corresponding 2-10 percent reduction in the conventional revenue estimate in the first two years. As the policy change ends, these effects begin to reverse themselves. Thus, for the first five years of the budget horizon, the bill would raise real GDP between 0.1 percent and 0.6 percent, while in the second five years of the budget period, 2016-2020 real GDP declines relative to present law as growing deficits crowd out private investment and reduce future revenues. A more complete analysis can be provided on request.

5. Dr. Elmendorf's testimony indicates on page 2 that "households bear the burden of corporate income taxes, but the extent to which they bear that burden as owners of capital, workers, or consumers is not clear." Is this just another way of saying that corporations don't pay tax, people do?

   Do we have any idea of how progressive the corporate income tax is when considering the fact that its tax burden falls on various households?

   Answer:

   It is true that corporations do not bear the ultimate burden of taxation, people do; however, there is uncertainty about which people bear the burden. Owners of capital may bear the tax in the form of lower returns, workers in the form of lower wages, consumers in the form of higher prices, or some combination thereof. It is not possible to determine the progressivity of the corporate income tax unless and until a judgment is made about which households bear the burden of the tax and to what extent. Consensus on which households bear the burden of the tax and to what extent is not forthcoming.

Questions from Senator Ensign

1. Please comment on how tax law affects decisions by investors on how to organize their businesses, i.e., whether to operate as a sole proprietorship, partnership, C- or S-corporation, or other entity. Has there been a change over time, and if so, why?

Answer:

Over the past three decades, there has been a shift in the choice of business entity away from C corporations to flow-through entities, such as partnerships and S corporations. As noted in my testimony, one reason for this shift is that over time the differences in the corporate and individual tax rates have been reduced. In the mid-1970s, the top individual tax rate on investment income was 70 percent whereas the top corporate tax rate was 46 percent. Additionally, changes to the tax laws in 1986 made it more costly to distribute appreciated property from a C corporation to its shareholders tax-free.

Another reason for the shift in business entities away from C corporations is a change in State law which permits the formation of limited liability entities, coupled with the issuance of the so-called "check-the-box" regulations, which allows such entities to be taxed as partnerships. These limited liability entities provided the liability protection of a corporation, which enabled financial markets to aggregate capital for investment outside of the established stock exchanges. The check-the-box regulations have also led to the proliferation of entities that may be recognized for State law or foreign purposes, but disregarded (i.e., treated as a branch or division of the owning member) for Federal tax purposes.

Our staff has published a more in-depth analysis of the different business entities, and the evidence of and reasons for the shift away from the C corporation entity. See Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity*, (JCX-48-08), June 4, 2008.

2. What would be the revenue and administrative impact of moving to a unified method of taxation for businesses so that all business income would be taxed once and by a separate business tax rate structure?

Answer:

The revenue and administrative impact of any unified method of taxation that seeks to tax business income once at a separate business rate structure would depend on the approach selected. Factors affecting revenue include the rate structure, the degree of any base broadening (or reductions of the tax base), transition, and administrability. Administrability depends on whether collection is affected by imposing tax at the investor (as compared to the entity) level; treatment of exempt investors (if retained) and cross border transactions; the extent of remaining valuation and allocation issues, and whether it remains necessary to differentiate among categories of income and expense that might be recast in economically similar but differently treated forms.

Under the present law corporate income tax, returns to investors may bear more than one level of tax if income is recognized by taxable persons at both the corporate and investor levels. However, if the recipient investors are domestic tax exempt entities, or enjoy full or partial tax exemption as foreign investors or otherwise, then one level of corporate tax may be the only level collected. Less than one level (or no tax at all) may be collected on returns to exempt or partially exempt investors if such returns are deductible by the corporation (for example, as interest on debt rather than as nondeductible dividends on equity) or are deferred under corporate or business tax rules. The choice of how to treat such factors under a unified method of taxation would have significant effects.

There have been a number of proposed methods to "integrate" the corporate level income tax (i.e., to reduce or eliminate the double tax effect of this tax where such occurs), for example by crediting equity investors with the corporate tax paid (for example, as discussed in an American Law Institute Reporter's Study[9]) or by exempting certain investor level returns (including a "Comprehensive Business Income Tax" proposal in a Treasury Department study, that would generally disallow corporate tax deductions for interest to achieve conformity with dividends, in addition to exempting investor level returns on both debt and equity to the extent taxed at the entity level).[10] See Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Tax Issues,* (JCX-41-06), September 19, 2006, at pp. 26-30; Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes* (Tax Analysts 1998). For additional discussion of these proposals see Michael L. Schler, "Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models, " 47 *Tax Law Review* 509 (1992).

Other proposals regarding a business tax include proposals that are wholly or partially based on consumption tax models. See e.g. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd edition, Stanford, California: Hoover Institution Press (1995); David F. Bradford "A Tax System for the 21st Century," in *Toward Fundamental Tax Reform,* edited by Alan Auerbach and Kevin Hasset, AEI Press, Washington, D.C. (2005); see also Edward D. Kleinbard, "Rehabilitating The Business Income Tax" (Brookings Institution, Hamilton Project, discussion paper 2007-09 (2007).[11]

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[9] Alvin C. Warren, Jr., *Integration of Individual and Corporate Income Taxes,* American Law Institute (1993).

[10] U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (1992).

[11] For further discussion of the Kleinbard and other proposals, see Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal,* 2008 Tax Notes 921 (February 25, 2008) and letters to the editor of *Tax*

3. The President's Commission on Fiscal Responsibility and Reform recently proposed, "To eliminate all tax expenditures for business." Some of the largest tax expenditures, however, involve acceleration of depreciation for investments. What would be the impact on U.S. business, investment, and employment by eliminating all such measures related to timing of deductions for depreciation in order to decrease the corporate tax rate?

   Answer:

   Replacing a system of accelerated depreciation with a system of economic depreciation, in which depreciation deductions reflect the economic life of the property, and a reduction in the corporate income tax rate would likely benefit owners of existing capital relative to new capital investments. Existing capital will have benefited from any accelerated depreciation deductions taken as of the date of the change, while new investments will face less generous depreciation schedules. The returns to both existing and new capital investments will benefit from the lower corporate tax rate.

   To the extent that accelerated depreciation schedules disproportionately favor investments in certain sectors of the economy relative to others, elimination of these distortions would improve economic efficiency.

4. The President's Commission on Fiscal Responsibility and Reform recently proposed, "'To bring the U.S. system more in line with our international trading partners,' we recommend changing the way we tax foreign-source income by moving to a territorial system." What would be the impact on revenue from adopting that proposal? Would it greatly simply the tax system for U.S. firms as well as the government?

   Answer:

   The revenue and simplification effects of a proposal to exempt some or all foreign-source income from taxation depend upon the particular proposal, including other changes accompanying the reform that generally may affect the taxation of business income. The revenue consequences turn on whether taxpayers are encouraged or discouraged by the proposal to undertake activities, including investment in the United States, affecting the U.S. tax base. Simplification effects include both mechanical (e.g., form filing) issues and business operating procedures (e.g., transfer pricing choices).

   Important details in the exemption proposal include the breadth of the exemption, the treatment of domestic expenses that are allocable to the exempt income, the treatment of passive income, and the transition rule for the stock of deferred income that has not been

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Notes from Edward D. Kleinbard, 2008 TNT 63-35 (April 1, 2008) and 2008 TNT 43-38 (March 4, 2008); from Alvin C. Warren, 2008 TNT 53-40 (March 18, 2008), and from Daniel S. Shaviro, 2008 TNT 43-47 (March 4, 2008).

repatriated at the time of the reform's enactment. We discuss the details of the revenue and simplification effects of a particular exemption proposal in our pamphlet *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05 (January 29, 2005). In addition, the larger context of a reform proposal will have implications for the impact of an exemption proposal: for example, the larger the reduction in the general U.S. tax rate engendered by a broad reform effort, the greater the incremental simplification and positive revenue effects from a territorial proposal that is part of the broad reform effort.

5. One objection sometimes raised against moving to a territorial system is that it would lead U.S. firms to move overseas or might lead to abuses through transfer pricing. Yet, most of the worlds' leading industrial economies have a territorial system, some moving recently even in the midst of a worldwide recession. Can you explain how other countries have handled the challenge of adopting and managing a territorial system, and is there anything unique about the U.S. system to suggest our tax enforcement officials are not able to prevent abuses? What is the current loss of revenue from transfer pricing abuse? If all of the President's proposed changes to transfer pricing were adopted, would this effectively end potential abuse?

Answer:

The tax laws of the United States and most of our major trading partners include transfer pricing rules that are generally consistent with guidelines developed by the Organisation for Economic Co-operation and Development, of which the United States and most of our major trading partners are members. See Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010). These principles generally do not depend in their application on whether the country adopting them employs a worldwide or territorial tax regime. Thus, when a country transitions from a worldwide to a territorial tax regime, significant changes in that country's transfer pricing rules are not generally adopted.

Transfer pricing is a challenging issue for all countries, regardless of whether they have a worldwide tax regime like the United States or a territorial tax regime. Under either type of regime, taxpayers have incentives to utilize transfer pricing to minimize their overall tax burdens. It may be argued that any tax regime other than a pure worldwide regime–one in which every dollar a taxpayer earns, regardless of source, is currently taxed–may present opportunities for taxpayers to use transfer pricing to minimize their tax liabilities. No country has adopted such a regime.

Additional information about these issues may be found in our recent publication, Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, which includes a background discussion of business restructuring, a description of present U.S. tax law, including transfer pricing rules, and six case studies of U.S.-based multinational corporations and how the business structures of those corporations interact with the U.S. tax laws. The case studies presented focus on U.S-based multinational corporations, but foreign multinational corporations may use structures similar to those described to obtain business and tax benefits even when located in jurisdictions that have territorial regimes.

6. For U.S. firms that operate with overseas affiliates, what is the average effective rate for their overseas affiliates and how does it compare to competing foreign- owned firms in those same markets? Does deferral of U.S. tax and the ability to operate on an equal basis under foreign tax laws allow U.S. firms to operate competitively? How would ending deferral affect the comparative effective rates for U.S. foreign affiliates versus foreign-owned firms in the same market?

Answer:

Some people argue that the ability of U.S. multinational corporations to defer U.S. taxation of active foreign earnings is a critical factor in allowing U.S. multinational corporations to compete with foreign competitors based in jurisdictions that have territorial tax regimes by helping to equalize the rate of tax effectively imposed on the earnings of their foreign affiliates. These people would therefore contend that ending deferral for U.S. multinational corporations would place such corporations at a competitive disadvantage with their foreign competitors by increasing the residual U.S. taxation on their active foreign earnings. Other people argue that ending deferral would not create competitiveness problems for U.S. multinational corporations, which have been, and remain, highly successful for reasons independent of the U.S. international tax regime. Additional discussion of these issues may be found in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposals* (JCS-2-10), pages 218-20, August 16, 2010.

7. The Federal Reserve recently announced it would follow a policy of quantitative easing by buying up to $600 billion in U.S. Treasuries and thus inject that cash into the economy through the financial system. That is intended to add liquidity to the financial system and promote investment and spending. Would encouraging U.S. firms to repatriate half a trillion dollars in cash held overseas at a reduced tax rate effectively result in a similar or better effect by allowing money for investment and more liquidity in the U.S. banking system?

Answer:

Comparing the economic effects of quantitative easing with the economic effects of a tax reduction on repatriated overseas corporate profits is highly uncertain. Quantitative easing has not been in place for long enough to fully determine its economic effects and costs, though preliminary evidence shows that the first round of easing decreased interest rates somewhat. As to repatriation, economic studies so far have not shown any positive investment effect. Currently, approximately $670 billion of domestically-held liquid assets (potentially available for investment) are held by firms in the manufacturing, mining, wholesale, and retail trade sectors, according to the Census Bureau's Quarterly Financial Report. Thus, a reduced tax rate on repatriation could potentially have little effect on liquidity and investment if it primarily affected the same firms that currently have large amounts of liquid assets. But it could have some effect if it affected other firms that are otherwise liquidity constrained and have lower reserves.

Questions from Senator Enzi

1. A series of proposals and recommendations have recently been offered to restore the nation's fiscal balance, with tax reform being a significant contributor to such an effort. For example, the final report from the National Commission on Fiscal Responsibility and Reform recommends a move to a territorial tax system as part of reforming the corporate tax structure. Such a move could have a significant impact on the organizational structure and operations of both small and large U.S. multinationals, as well as potentially significant financial statement impacts. Given this, it would be prudent to include appropriate transition rules in any tax reform effort. What should be taken into consideration as part of any transition plan, both with respect to the individual and corporate tax systems?

   Answer:

   Transition rules are important to any tax reform effort. These rules should balance traditional economic concerns, including efficiency and equity, while promoting the new tax reform as it becomes law. A variety of effects should be considered in transition, including the impacts of comprehensive tax reform on States, other countries (including tax and other treaties with other countries), domestic and multinational companies headquartered in the United States and their competitors, and nonprofit organizations. Consideration should be given to prior economic decisions shaped by the tax regime that is being replaced, including decisions of taxpayers in their capacities as workers, retirees, investors, and members of various institutions that act as intermediaries for tax and other purposes.

   In addition to efficiency and equity issues, administrability, revenue needs, interactions among the components of a tax reform, and timing concerns affect the design of transition rules.[12] While the complexity of transition issues may be daunting, there is support for the notion that principled transition rules bridging to a beneficial tax reform can achieve near-term benefits in many areas, although for sure there still will be questions of compensation for the taxpayers that are adversely affected, even if only short-term, in most tax reform efforts.[13] It is important to recognize that appropriate

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[12] Sundry tax and non-tax issues may affect the design of tax reform. For example, to attain largely non-tax generational equity (although the phase-in did have tax implications), the Social Security reform in 1983 took account of the proximity of workers to retirement at the time of enactment, using a long-term phase-in to change the eligibility age for normal retirement. As examples of non-tax considerations for tax reforms affecting businesses, transition rules should be mindful of compliance costs and financial accounting effects.

[13] Martin Feldstein ("On the Theory of Tax Reform," *Journal of Public Economics*, vol. 6, pp. 77-104, 1976) addressed the general notion of transition in tax reform, identifying circumstances under which the benefits from reform outweighed transition costs. In addition, an important Department of the Treasury study overseen by David F. Bradford (*Blueprints for Basic Tax Reform*, January 17, 1977), and more recently the volume edited by Kevin A. Hassett and R. Glenn Hubbard (*Transition Costs of Fundamental Tax Reform*, AEI Press, Washington,

transition rules take time to formulate - in that regard, the two-year process from introduction of the President's Tax Reform Proposal in 1984 to its enactment as the Tax Reform Act of 1986 may be instructive (and this two-year period does not count the groundwork that led up to the initial 1984 proposal), and much of that two-year period involved the crafting of transition rules.[14]

Transition to a territorial tax regime should include many of the above considerations, with special emphasis on the tax and accounting effects of transition for the stock of deferred earnings currently invested overseas. These transition issues are discussed in a JCT staff publication presenting a proposal to adopt a dividend exemption system for foreign business income.[15]

2. A common complaint of taxpayers is that the current income tax system is overly-complex, and complying with the rules and requirements of the Internal Revenue Code and its thousands of pages of regulations is costly and burdensome. Many proposals have been offered identifying how Congress might approach changes to the tax system for the purpose of simplifying and streamlining the tax laws. What are the considerations of undertaking such an effort both within and outside the context of deficit/debt reduction? How might the effects of such changes be more pronounced for certain taxpayers? How might such changes impact the "tax gap?"

Answer:

All else being equal, a simpler tax system is desirable to reduce the costs of compliance with the tax laws. In considering measures to simplify the tax laws, one faces tradeoffs between the simplicity of the tax Code, equitable treatment of taxpayers, and economic efficiency. For example, it would generally be simpler to tax only wages and not capital income, but many might see that as inequitable as capital income more heavily accrues at the top of the income distribution. Additionally, to raise the same revenue, the tax rates on wage income would need to be greater than the rates that would apply to all income, as the wage base is smaller. This could exacerbate economic inefficiencies in labor markets that arise from taxation. Simplification and improvements in economic inefficiencies can be achieved simultaneously, however. Economists across the political

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DC, 2001), suggest that the transition issues associated with a reform that reduces the tax on capital investment are surmountable. Examples of transition relief in the other direction, that is, relief in cases of a reform that increases taxes on capital investment, can be found in the numerous transition rules contained in the Tax Reform Act of 1986 to relieve investors deemed worthy because they were expected to be facing tax increases under the new law.

[14] Even what seemed like major policy changes in the reform during that period often were caused by transition issues.

[15] Item VI.D in *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05 (January 29, 2005).

spectrum have broadly supported a broadened tax base and lower tax rates. The lower tax rates would improve economic efficiency by reducing economic distortions caused by taxation, and to the extent that the broadened base was achieved by eliminating special preferences in the tax code for certain activities, the tax code could be made simpler as well. Eliminating preferences could make the Code more or less equitable, depending on one's view of a given preference. Preferences can create or correct perceived inequities in the Code.

With respect to deficit or debt reduction, the tax code could be simplified in ways that lead to more or less revenue. For example, the income-based phaseouts of numerous benefits in the Code create complexity, and could be eliminated for simplicity, but with a revenue cost. Alternatively, they could be eliminated, with modest increases in rates (or other simple revenue raising measures), to achieve revenue neutrality or to raise revenue. Either approach would yield a simpler tax code.

The effect of simplification on different groups will depend on the specifics of the simplification measure. Increasing the standard deduction would simplify the system and lower taxes for middle and lower income groups, but do nothing for those that continue to itemize deductions. Alternatively, eliminating the phaseouts of itemized deductions will help only upper income taxpayers subject to the phaseout. Simplification measures achieved by eliminating special preferences will of course impact only those who availed themselves of the preferences–the code might then be simpler for them to comply with, but at the price of paying higher taxes.

The tax gap could be decreased by certain simplification measures for various reasons. A simpler system could produce fewer opportunities for errors and noncompliance, make a given level of IRS audit resources more effective, and could possibly improve the perceived fairness of the tax system, which might lead to improved voluntary compliance.

3. It's been offered that tax expenditures have the effect of altering individuals' and companies' economic behavior, which might lead to less-than-optimal resource allocations. On the one hand, the final report from the National Commission on Fiscal Responsibility and Reform recommended eliminating nearly all tax expenditures and reducing income tax rates, the effect of which would lessen such distortions. On the other hand, Martin Feldstein suggested in a recent *Washington Post* article implementing rules to cap the benefit taxpayers receive from the combined effect of different tax expenditures (with no reduction in the types or numbers of tax expenditures). To what extent would this proposal have an effect on economic behavior and efficient resource allocation? Just as important, what might the impact of this type of proposal have on simplifying the tax laws and streamlining their administration?

Answer:

Capping tax expenditures in the way suggested by Martin Feldstein in his November 29, 2010, *Washington Post* article[16] would reduce the economic incentives for taxpayers subject to the cap to engage in additional tax-favored activities. To the extent the affected tax expenditures correct a market distortion, a cap leads to less efficient resource allocation; however, to the extent those tax expenditures create their own distortionary effects, a cap results in more efficient resource allocation. Because all the underlying credits, deductions, and other tax benefits remain in place under Mr. Feldstein's proposal, a cap does not simplify the tax laws or streamline tax administration. Rather, it may have the opposite effect, by requiring taxpayers and tax administrators to make additional calculations to determine whether and the extent to which the cap applies.

Questions from Senator Snowe

1. Dr. Barthold, I would like to discuss the issue of a cost/benefit analysis with respect to revenue provisions bearing in mind the particular case of the 1099 mandate. When enacting tax gap closing measures or other revenue provisions, we must have some sense of proportion to these matters. It makes no sense to "spend a dollar to collect a penny or a dime."

   For instance the CBO testimony states that for all the time and expense that goes into corporate tax compliance, in 2010 it is estimated to collect roughly 7 percent of the revenue of the Federal government. Further, we have been caught in an intractable effort to repeal a paperwork reporting nightmare regarding 1099s for which compliance costs, by one estimate, could exceed 100 times the amount of revenue collected. Two weeks ago, the Small Business Committee held a hearing and the GAO testified on the compliance costs of this 1099 mandate.

   Dr. Barthold, the House has debated a proposal that would direct the Joint Committee on Taxation to provide to the tax writing committees a mammoth report analyzing tax expenditures including "unintended effects" and the efficacy of the expenditures. If the Joint Committee were to produce such reports, would you consider a disproportionate cost of implementation to be a possible "unintended effect"? I believe that such a cost/benefit analysis would be a useful component of such a report and would like to suggest that this be included.

   Answer:

   As passed by the House on May 28, 2010, H.R. 4213, the American Jobs and Closing Tax Loopholes Act of 2010, included a provision requiring that the Chief of Staff of the

[16] Martin Feldstein, "How to Cut the Deficit Without Raising Taxes," *Washington Post*, November 29, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/11/28/AR2010112802912.html.

Joint Committee on Taxation to conduct a report on certain tax expenditures extended by the bill.

Among other things, the report is to include a description of any unintended effects of the tax expenditures that are useful in understanding the tax expenditure's overall value. You ask, if such reports were produced, whether the Joint Committee on Taxation would consider a "disproportionate cost of implementation" an unintended effect. The Joint Committee on Taxation would generally consider any costs, but particularly high costs, of implementing and complying with a tax provision to be undesirable, and thus not an intentional feature of the tax provision, even if such costs are known to exist at the time of passage.

2. I would like to hear from each of our witnesses about the juxtaposition of two sets of data presented today. (charts below) The CBO testimony indicates that there has been a dramatic increase in wealth reported in the top income quintile – this statistic is often reported as a "the rich are getting richer and the poor are getting poorer." Separately, we have heard testimony that there has also been a dramatic rise in the number of sole proprietorships, S Corps and partnerships. The Joint Committee has stated that 50 percent of all income in this upper bracket is attributable to flow-throughs.

   Given the juxtaposition of the rise in number of businesses that are taxed at the individual rates and the rise in wealth in that bracket, it would appear to me that much of that income is actually small business income that is taxed at the top two rates. Small businesses depend upon reinvested profits as the most significant and most accessible source of capital so it is vital to small business well being that we are cautious about raising taxes that send these funds to Washington rather than to reinvestment. **So, I would like to know from the witnesses how much of that rise in wealth is really the result of the greater <u>number</u> of flow-through entrepreneurial establishments that are reporting business income?**

   <u>Answer:</u>

   It is possible that some of the growth in income inequality as reported on individual tax returns is the result of the choice by individuals to organize business activities in a pass-through form, where such business income is reported directly on individual tax returns, rather than as a C-corporation, whose income is not directly reported on individual tax returns.[17] There has been significant growth in the number of tax returns showing Schedule E income in recent years. In 1985, 2.5 million returns, or 2.4 percent of all

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[17] See, for example, Roger Gordon and Jeffrey Mackie-Mason, 1990, "Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form," in Joel Slemrod, ed., *Do Taxes Matter?* (Cambridge: MIT Press), 91-131; and Daniel R. Feenberg and James M. Poterba, "Income Inequality and the Incomes of Very High-Income Taxpayers: Evidence from Tax Returns," in James Poterba, ed., *Tax Policy and the Economy*, Vol. 7, Cambridge, MA, The MIT Press, 1993.

returns, had positive Schedule E net income and reported $48.5 billion dollars (current) of such income, or 2.1 percent of aggregate AGI that year. By 2008, those figures grew to 5.1 million returns, or 3.6 percent of all returns, reporting $547 billion or 6.3 percent of aggregate AGI.

3. It is possible that some of the growth in income inequality as reported on individual tax. The growth in the number of flow-through businesses is critical to understanding why the increase in individual rates is so damaging to small business job generation. There has been tremendous growth in the number of sole proprietorships since 1980. Since 1997, there have been more S Corporations than C Corporations.

   In April 2009, the Small Business Administration Office of Advocacy released a study titled Effective Tax Rates Faced by Small Businesses. I believe this is a unique study of this issue and it found that, for the particular subset of small businesses in the study, that the effective tax rate for the year 2004 was 19.8 percent. By each entity type the rates were:

   - 13.3 percent for sole proprietorships (non-farm)
   - 23.6 percent for small partnerships
   - **26.9 percent for small S Corporations**
   - 17.5 percent for small C Corporation (additional tax on distributions)

   Unfortunately, the subset of businesses in the study was those with less than $10 million of assets, so it limits some of the utility of this data regarding businesses such as construction contractors and manufacturers that would otherwise still be considered "small businesses" but have large amounts of assets.

   As experts in the field of tax policy data, do you have a general sense of the definition of "small business" in the tax context is measured by number of employees or by gross receipts tests? In what contexts have you seen an assets threshold used to determine small business?

   Would it be possible for the Joint Committee on Taxation to review this SBA study (which I understand was performed by a former Joint Tax staffer) and determine whether the data could be replicated with a different classification, such as by gross receipts, and also for more recent data than for 2004?

   Answer:

   The 2009 study released by the Small Business Administration Office of Advocacy ("Effective Federal Income Tax Rates Faced by Small Businesses in the United States") dated April 2009 used as its measure of a small business whether a business had gross receipts of less than $10 million. The study noted that "the IRS defines small businesses as those entities with less than $10 million of assets."

   The Internal Revenue Code uses various measures for a small business. Examples of Code sections where assets or capital are used to determine whether a taxpayer is a small business include sections 806 (small life insurance company deduction), 1202 (exclusion of capital gain from small business stock), and 1244 (losses on small business stock). Gross receipts is also used in determining whether a business is a small business. For example, sections 38 (eligible small business credits), 55 (exemption for small corporations), 263A(b) (small reseller exception), 448 (use of cash method), and 460 (small contractor exception) provide for special rules for small taxpayers. The number of employees is also used as a measure of a small business. See for example, sections 41(eligible small business contract research), 45E (small employer pension start-up costs), and 408(p) (SIMPLE retirement accounts).

The Code also looks to production or capacity. See for example, sections 40(b)(4) (small ethanol producer credit), 40A(b)(5) (small agri-biodiesel fuel producer credit), 45 (credit for electricity produced from certain renewable sources), 45H (credit for production of low-sulfur diesel)) and phases out the benefit of expenses at certain higher investment levels (for example sections 179 (election to expense certain depreciable property), 181 (treatment of certain qualified film and television production), 195 (start-up expenditures), and 248 and 709 (organizational expenditures) as a means of providing tax benefits to small businesses.

The study itself, in analyzing effective tax rates facing small businesses, is handicapped by the limited data available. In order to provide a definitive analysis of the effective tax rates faced by small business, the analyst would need access to a data set that combines tax return information on business entities (e.g. corporate, partnership, sole proprietorship) with the tax return information of their owners (individual, partnership, and corporate). With such a dataset, one could potentially start with a business that is of interest, and trace back to all of its ultimate owners. However, to do so potentially requires tracing back through multiple levels of ownership, possibly including offshore entities. While an IRS audit could potentially trace through all the levels, it may not be feasible for an analyst to do so, absent IRS audit resources. To the extent that it is possible to track down all of the owners of a business, it is then possible to characterize each owner's tax rate. A complicating factor, however, is that there will often be different tax rates faced by a business's different owners, so it is not straightforward to say which tax rate most affects the business's decisions. One could potentially determine a weighted average tax rate based on the weighted shares of ownership of the business. But this would potentially be misleading if there is a majority owner or a controlling interest of owners whose tax rate differs from the average.

In any case, a definitive dataset as described above was not available to the study's authors, so they used statistical and other methods to approximate the relevant ownership and tax relationships. Thus, the effective tax rates shown in the study, while not in any sense unreasonable, should be viewed as only being approximate.

Although a "perfect" dataset of the type described above is not yet available, preliminary work has been done to construct a dataset for examining tax relationships between businesses and their owners. A paper by Nicholas Bull, Susan Nelson, and Robin Fisher on "Characteristics of Business Ownership: Overview for Passthrough Entities and Evidence on S Corporate Ownership from Linked Data"[18] reports on preliminary work that examines relationships between S Corporations and their individual owners. The paper examines S corporations because with few exceptions, the owners are required to be individuals who are U.S. nationals, and therefore the relationships in the data are easier to find and examine. The paper does not report average tax rates, and therefore cannot be directly compared to the study referred to above.

4. The income tax code is progressive, in that it provides a lower rate of tax on lower income people and higher taxes on upper income people. In 2006, we have been told the two bottom quintiles actually had a negative tax rate so that people with incomes under $34,000 received back more from the income tax system than they paid. The wealthiest income quintile had a 14 percent effective tax rate while the richest 1 percent had the highest tax rate of 18.9 percent. Policymakers can argue about whether these are appropriate levels of tax, but they are certainly progressive.

   Clearly the recession and other tax incentives from the stimulus have changed the distribution of taxes since 2006, according to Dr. Elmendorf's testimony, and knowing the current state of play is going to be essential to good policy making regarding long term tax rates. **How soon can we get data about effective tax rates for the years 2007 through 2010? If there is data available for any of those years can you please provide this?**

   Answer:

   The Congressional Budget Office uses data from the Statistic of Income (SOI) to calculate average effective tax rates for households. SOI data on individual income taxes is available for tax years 2007 and 2008. Data for tax year 2009 will be released in June, 2011. SOI data on individual income taxes for 2010 should be available in June, 2012.

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[18] Forthcoming, *National Tax Journal.*

COMMITTEE ON FINANCE
NEWS RELEASE
Max Baucus (D-Mont.)
http://finance.senate.gov

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Historical Trends in Income and Federal Revenues

A tax system expresses a society's values.

America's always changing. That's one of our strengths.

That change also means that, periodically, we need to consider whether our tax system continues to express the values that we want to put first.

To consider where we want to our tax system to go, we need to understand where we are and understand where we've been.

In September, the Committee kicked off a series of hearings on tax reform. We examined the environment that produced the 1986 tax reform.

Today, we look at historical trends in income and in taxes. This will give us useful background as we roll up our sleeves for tax reform.

First, we need to examine where Federal revenue comes from.

The composition of Federal revenue has changed significantly since World War II. As a percentage of total revenue, Social Security taxes have increased and corporate and excise taxes have decreased.

For example, in 1950, corporate income taxes provided 30 percent of Federal revenue. But by 2009, they made up only seven percent.

In the 1950's, excise taxes produced 19 percent of Federal revenue. By 2007, they comprised only three percent.

Over the same period, social insurance taxes — like Social Security and Medicare taxes — more than quadrupled. In 1950, they provided about 10 percent of Federal revenues. By 2009, they generated 42 percent.

Why has the composition of Federal revenues changed so dramatically?

Should we be concerned that the share of revenue raised by the corporate income tax has declined by more than 75 percent? Is that a result of an increasingly global economy? Is it because the corporate tax base is too narrow?

Or is it linked to the fact that the share of business income subject to the corporate income tax — as opposed to the share taxed on a pass-through basis — has fallen from about 70 percent to about 43 percent, over the past quarter century?

Is it a cause for concern that fewer businesses are structuring themselves as corporations? Did more businesses structure themselves as corporations in the past because corporations were used as tax shelters? Or was it because we now tax corporations too heavily?

Answers to questions like these will help us know where we are going on corporate tax reform.

Second, we need to understand the distribution of income and Federal taxes.

In 1980, the richest one percent of Americans received about nine percent of total income. By 2006, this share more than doubled, to about 19 percent.

Meanwhile, the share of total income received by the 20 percent of households with the lowest incomes fell from about six percent to about four percent.

Over this period, average tax rates fell for all households, including the richest one percent. The share of Federal taxes paid by the top one percent grew. But this group's share of income grew even faster. As a result, over the past quarter century, the share of after-tax income received by the richest one percent has doubled, from about eight percent to 16 percent.

Meanwhile, the share of after-tax income declined for almost all other households. For example, the share of the middle fifth of taxpayers fell from about 16 percent to 14 percent.

Why are these trends occurring? Are highly-paid workers working harder, relative to other workers, than they did in the past? Or are changes in the economy failing to benefit low- and middle-income workers?

Has the tax code kept up with these broad changes in the economy?

We need to understand how tax burdens are allocated, and how they have been allocated in the past.

Third, we need to look at how America compares to our global competitors.

We need to have a tax code that encourages companies to locate and grow in America. We need to help to create American jobs.

We need to ensure that America maintains our global competitiveness. American companies will win when they compete with foreign companies, provided they compete on a level playing field.

But we also need to ensure that our tax code needs to promote the growth of our economy and the creation of jobs.

I often hear that we need to change the tax code to level the playing field for American companies. Today, we'll ask how our tax system compares with our major competitors.

And so, let us consider the way that the American economy has changed. Let us think about whether we need to change our tax system, as well. And let us seek to ensure that our tax system expresses the values that we as a society want to put first.

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

Trends in Federal Tax Revenues and Rates

before the
Committee on Finance
United States Senate

December 2, 2010

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, December 2, 2010. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Pub. No. 4220

Notes and Definitions

Numbers in the exhibits and text may not add up to totals because of rounding. Unless otherwise indicated, all years referred to are calendar years.

The Congressional Budget Office's (CBO's) analysis of average tax rates draws information on income and taxes from two primary sources: the Statistics of Income, a nationally representative sample of tax returns compiled by the Internal Revenue Service, and the annual Demographic and Economic Supplement to the Census Bureau's Current Population Survey. CBO calculates income and estimates federal taxes for each household in the sample in each year on the basis of income, demographic characteristics, and existing laws in the relevant year.

Average tax rates are calculated by dividing taxes by comprehensive household income. A negative average income tax rate results when refundable tax credits, such as the earned income and child tax credits, are greater than the income taxes owed by people in that group. (Refundable tax credits are not limited to the amount of income tax owed before they are applied.)

Comprehensive household income equals before-tax cash income plus income from other sources. Before-tax cash income includes labor income (wages, salaries, and self-employment income), capital income (rents, taxable and nontaxable interest, dividends, and realized capital gains), cash transfer payments (Social Security retirement and disability benefits, unemployment insurance benefits, and cash assistance for low-income families), and retirement benefits; it also includes taxes paid by businesses (corporate income taxes and the employer's share of Social Security, Medicare, and federal unemployment insurance payroll taxes) and in-kind benefits (Medicare and Medicaid benefits, employer-paid health insurance premiums, nutrition assistance, school lunches and breakfasts, housing assistance, and energy assistance).

Income categories are defined by ranking all people by their comprehensive household income adjusted for household size-in particular, by dividing income by the square root of the household's size. (A household consists of the people who share a housing unit, regardless of their relationships.) Quintiles, or fifths, contain equal numbers of people. Households with negative income are excluded from the lowest income category but are included in totals.

In assessing the impact of various taxes, individual income taxes are allocated directly to households paying those taxes. Social insurance, or payroll, taxes are allocated to households paying those taxes directly or paying them indirectly through their employers. Corporate income taxes are allocated to households according to their share of capital income. Federal excise taxes are allocated to households according to their consumption of the taxed good or service.

List of Exhibits

Trends in Federal Tax Revenues and Rates

Chairman Baucus, Senator Grassley, and Members of the Committee, thank you for the invitation to testify on historical trends in income and revenues. My testimony addresses revenues collected by the federal government, how taxes affect economic activity, and the tax burden and who bears it. Other elements of the current tax system—such as its complexity and the resulting costs of compliance—are also important but are not addressed here.

Federal Revenues: Trends and Projections

Over the past 40 years, federal revenues have ranged from nearly 21 percent of gross domestic product (GDP) in fiscal year 2000 to less than 15 percent in fiscal years 2009 and 2010, averaging 18 percent of GDP over that span. Most of the revenues—about 82 percent in 2010—come from the individual income tax and the payroll taxes used to finance Social Security, Medicare, and the federal unemployment insurance program. Other sources of revenues include corporate income taxes, excise taxes, estate and gift taxes—all together about 13 percent of revenues in 2010—and nontax revenues such as earnings of the Federal Reserve System, customs duties, fines, and various fees. Variation in individual income tax receipts, stemming from both policy changes and economic developments, has generated the largest fluctuations in revenues as a percentage of GDP.

Under current law, revenues will rise significantly from their recent low relative to GDP as the economy recovers from the recession and the tax reductions enacted in 2001, 2003, and 2009 expire. The Congressional Budget Office (CBO) projects that under current law, federal revenues will reach 21 percent of GDP in fiscal year 2020, just above their peak share of 10 years ago.

CBO also projects that under current law, federal spending will decline for a few years relative to GDP and then increase again, reaching nearly 24 percent in 2020—slightly lower than the peak level of almost 25 percent in fiscal year 2009 but well above the average of roughly 21 percent over the past four decades. Compared with that historical experience, the components of federal spending that are projected, under current law, to be unusually large relative to GDP by 2020 are the expenditures for Social Security and the federal health programs (including spending for Medicare, Medicaid, and the subsidies to be provided in the new insurance exchanges); other nondefense spending is projected to roughly equal its historical share of GDP, and defense spending is projected to be a smaller share of GDP.

As a result, even with the projected substantial increase in revenues, under current law deficits between 2015 and 2020 will range between 2.6 percent and 3.0 percent of GDP. If lawmakers extended most or all of the 2001 and 2003 tax cuts and made no other changes to taxes and spending, revenues would be lower and deficits would be significantly larger.

How Taxes Affect Economic Activity: Marginal Tax Rates and Tax Expenditures

Taxes have an effect on the economy in addition to the revenues collected because they cause people to alter their economic behavior, which generally results in a less efficient allocation of resources. Taxpayers can respond in three general ways to taxes: They can change the timing of their activities, for example by accelerating bonus payments or the sale of assets into this year if they think tax rates on earnings or capital gains will increase next year; they can adjust the form of their activities, for example by substituting tax-preferred fringe benefits for cash wages if the tax rate on wages increases; or they can change more fundamental aspects of their behavior, for example by working or saving less if tax rates on earnings or capital income increase.

The crucial point is that taxes raise the price of taxed activities and thereby lower the relative price of other things. In particular, the income tax reduces the returns from working (the after-tax wage), which lowers the price of other activities relative to working; it also reduces the returns from saving (the after-tax rate of return), which lowers the price of current spending relative to saving for spending in the future.

One measure of the effect of taxes on the returns from working and saving is the marginal tax rate—the tax paid per dollar of extra earnings or dollar of extra income from savings. The highest marginal income tax rate (the tax rate that applies to the top income tax bracket) was 91 percent in the late 1950s and early 1960s and as high as 70 percent as recently as 1980, although a lower maximum rate applied to earnings in that year. Since 1988, the highest marginal income tax rate has ranged from 28 percent to 39.6 percent. For a representative family of four with median income, the marginal tax rate on earnings (combining the rates for both income and payroll taxes) during the period from 1955 to 1975 was around 20 percent. That rate climbed over the next 10 years as a result of rising payroll tax rates and inflation-driven increases in nominal incomes, which pushed median-income families into higher tax brackets. Following a reduction in income tax rates in 1986, the marginal tax rate for a representative median-income family has remained at about 30 percent.

Changes in marginal tax rates have two different types of effects on people. The lower that tax rates are, the more people can keep of the returns from additional work or saving, thus boosting people's incentives to work and save. But lower rates also have a countervailing effect: By raising after-tax income, they make it easier for people to attain their consumption goals with a given amount of work or savings, thus possibly causing people to work and save less. On balance, the evidence suggests that reducing tax rates boosts work and saving relative to what would occur otherwise, if budget deficits are held the same. But without any other changes in taxes or spending, reducing tax rates from current levels will generally lower revenues and increase budget deficits. Increased deficits, even with lower tax rates, can reduce economic activity over the longer term.

Provisions of the tax code can also affect economic activity by subsidizing certain types of expenditures. Until recently, most federal support for homeownership was provided through the tax code in the form of tax expenditures, which are revenues that are forgone because of special exclusions, exemptions or deductions from gross income, special credits, preferential tax rates, or deferrals of tax liabilities aimed at subsidizing certain activities. The largest and most widely used tax expenditure in the housing area is the deduction from taxable income for mortgage interest on owner-occupied homes, which results in an estimated $573 billion in forgone revenues from 2009 to 2013. That deduction encourages homeowners to buy homes and to take out larger mortgages than they might otherwise be able to afford, resulting in higher household debt, higher home prices in areas where the supply of housing is fixed, and less investment in other assets.

Another substantial tax expenditure is the exclusion of employers' contributions for health insurance premiums from income and payroll taxes. That exclusion encourages employers to offer health insurance to their workers and to pay their workers a larger share of their compensation in that form; the resulting higher levels of insurance increase demand for health care services. Tax expenditures have helped to accomplish various goals, but because they reduce the base to which taxes apply, tax rates must be higher to collect the same amount of revenues that would be collected in the absence of those subsidies.

The Tax Burden and Who Bears It

Households generally bear the economic cost, or burden, of the taxes that they pay directly, such as individual income taxes (including taxes paid on dividends, interest, and capital gains) and employees' share of payroll taxes. Households also bear the burden of the taxes paid by businesses. In particular, in CBO's judgment (and that of most economists), employers' share of payroll taxes is passed on to employees in the form of lower wages. In addition, households bear the burden of corporate income taxes, but the extent to which they bear that burden as owners of capital, workers, or consumers is not clear.

One measure of the tax burden is the average tax rate—that is, the taxes paid as a share of income. Federal taxes are progressive: Average federal tax rates generally rise with income. In 2007, households in the bottom fifth, or quintile, of the income distribution (with average income of $18,400, under a broad definition of income) paid about 4 percent of their income in federal taxes, while the middle quintile, with average income of $64,500, paid 14 percent, and the highest quintile, with average income of $264,700, paid 25 percent.

The largest source of federal revenues, the individual income tax, has average tax rates that rise rapidly with income. The next largest source of revenues, social insurance taxes, has average tax rates that vary little across most income groups—

although the average rate falls for higher-income households, because earnings above a certain threshold are not subject to the Social Security payroll tax and because earnings are a smaller portion of total income for that group. The average social insurance tax rate is higher than the average individual income tax rate for all income groups except the highest quintile.

Between 1979 and 2007, the average tax rate for federal taxes combined declined for all income groups. The average individual income tax rate also declined over those years; the largest decrease occurred for the fifth of the population with the lowest income. (That decline in average tax rates is based on a comparison of rates for different income groups at different points in time but does not reflect the experience of particular households, which may move up or down the income scale over time.)

The share of taxes paid by the top fifth of the population grew sharply between 1979 and 2007. Almost all of that growth can be attributed to an increase in that group's share of before-tax income. In 2007, households in the highest quintile earned 55 percent of before-tax income and paid almost 70 percent of federal taxes; for all other quintiles, the share of federal taxes was less than the share of income.

Related CBO Analyses

Further information about many of these issues is available in other CBO publications:

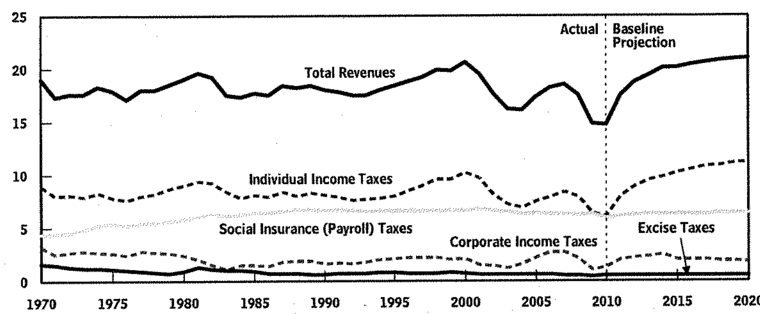
- Trends and projections of federal revenues are discussed in *The Budget and Economic Outlook: An Update* (August 2010); and *Sources of the Growth and Decline in Individual Income Tax Revenues Since 1994* (May 2008).
- Analyses of the effects of tax policy options on economic activity are discussed in Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices* (September 28, 2010); *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011* (March 2010); and *Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates* (December 2005).
- The effects of tax rates on economic activity are examined in *The Effect of Tax Changes on Labor Supply in CBO's Microsimulation Tax Model*, Background Paper (April 2007); *Computing Effective Tax Rates on Capital Income*, Background Paper (December 2006); *Effective Marginal Tax Rates on Labor Income* (November 2005); and *Taxing Capital Income: Effective Rates and Approaches to Reform* (October 2005).
- Subsidies to expenditures through the tax code are discussed in *An Overview of Federal Support for Housing*, Issue Brief (November 3, 2009); *Key Issues in Analyzing Major Health Insurance Proposals* (December 2008), pp. 29–37; *The Deductibility of State and Local Taxes* (February 2008); and Statement of Peter R. Orszag, Director, Congressional Budget Office, before the House Committee on the Budget, *Performance Budgeting: Applications to Health Insurance Programs and Tax Policy* (September 20, 2007).
- Supplemental analyses and detailed data on average federal tax rates and income, by income category, for 1979 to 2007, are available at www.cbo.gov/publications/collections/collections.cfm?collect=13.
- Issues involving tax rates and how household income changes over time are discussed in *Effective Tax Rates: Comparing Annual and Multiyear Measures* (January 2005). ◆

Federal Revenues: Trends and Projections

Exhibit 1.

Revenues, by Source, Fiscal Years 1970 to 2020

(Percentage of gross domestic product)



Source: Congressional Budget Office.

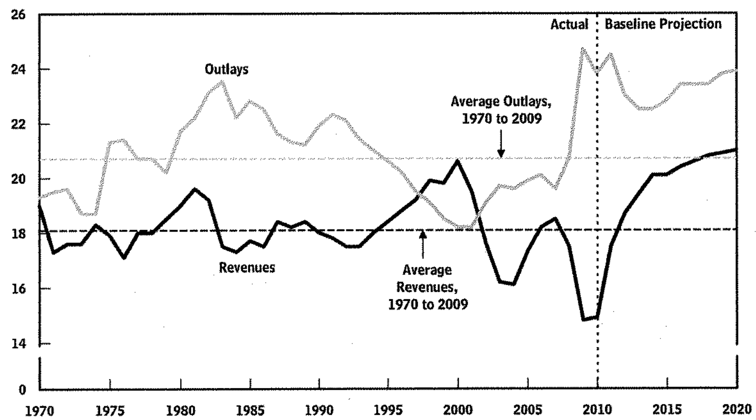
Total federal revenues have varied in relation to gross domestic product (GDP) over time, although they show no evident trend during the past 40 years. Over that span, federal revenues have ranged from less than 15 percent of GDP in fiscal years 2009 and 2010 to nearly 21 percent in fiscal year 2000 and have averaged 18 percent. The variations stem primarily from changes in receipts from the individual income tax related to both policy changes and economic developments. Over the past 40 years, revenues from payroll taxes have increased relative to GDP, reaching a peak of 7 percent of GDP in 2001 before declining to about 6 percent by 2010. Revenues from the corporate income tax and excise taxes have decreased relative to GDP since 1970.

Revenues as a percentage of GDP change over time because the size of the tax base for each source changes relative to GDP, because changes in the distribution of income can raise or lower average tax rates, and because changes in tax law affect the amount of revenues collected from a particular tax base. For example, the increase in revenues from social insurance taxes, measured as a share of GDP, between 1970 and 1990 primarily reflected legislated increases in Social Security and Medicare payroll tax rates as well as increases in the maximum earnings subject to tax. In contrast, much of the increase in revenues from the individual income tax between 1994 and 2000 occurred because the tax base was growing faster than GDP over that period (in part because a rising stock market increased the amount of taxable capital gains). ◆

Exhibit 2.

Total Revenues and Outlays, Fiscal Years 1970 to 2020

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Looking ahead over the next decade, CBO estimates that under current law, revenues will rise significantly relative to GDP, reaching 21 percent in 2020—slightly above the previous peak in 2000. That increase is attributable in part to the anticipated economic recovery and in part to the scheduled expiration of tax provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act of 2009 (including temporary relief from the alternative minimum tax, which has since expired). Revenues will also be boosted by provisions of the health care legislation enacted last spring (the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010), which are estimated to increase receipts by growing amounts over the next few years. In addition, the structure of the individual income tax will lead to gradual increases in receipts over time. As a result, under current law, revenues over the next decade are projected to be substantially higher than their average from 1970 to 2009.

However, under current law, spending over the next decade is also projected to be considerably higher than its average from 1970 to 2009. Even with the increase in revenues projected under current law, deficits are projected to range between 2.6 percent and 3.0 percent of GDP from 2015 to 2020, close to the average of 2.6 percent of GDP experienced over the past four decades. ◆

Exhibit 3.

Estimates of Revenues Under Current Law and Four Tax Policy Options in Fiscal Years 2011, 2012, and 2020

(Percentage of gross domestic product)

	2011	2012	2020
		Percentage of Gross Domestic Product	
Revenues Under Current Law	17.5	18.7	21.0
		Percentage-Point Change from Current Law	
Full Extension, Permanent [a]	-1.2	-1.7	-2.1
Partial Extension, Permanent [b]	-0.9	-1.4	-1.6
Full Extension, Through 2012 [c]	-1.2	-1.7	*
Partial Extension, Through 2012 [d]	-0.9	-1.4	*

Source: Congressional Budget Office based on preliminary information provided by the staff of the Joint Committee on Taxation.

Notes: Effects are estimated as revenues with the policy in effect minus revenues without the policy.

The estimates include the effects of increased outlays for refundable credits and do not incorporate any impact that the policy options might have on gross domestic product or other broad measures of economic activity.

* = less than 0.1 percentage point.

a. This option would extend the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 that are scheduled to expire at the end of 2010; extend the higher exemption amounts from the individual alternative minimum tax that were in effect in 2009 (adjusted for inflation) for 2010 and subsequent years; and reinstate the estate tax—which expired completely in 2010—for 2011 and subsequent years at the rates in effect in 2009 and with the exemption amounts (adjusted for inflation) that applied in that year.

b. This option is the same as the full extension, except that certain provisions would expire that would otherwise have applied to married couples with income of $250,000 or more and single taxpayers with income of $200,000 or more. Those provisions include the lower tax rates in the top two income tax brackets, the lower 15 percent tax rates on capital gains and dividends, and the elimination of the phaseout of itemized deductions and personal exemptions.

c. This option would make the same changes as the full extension, but through 2012 rather than permanently.

d. This option would make the same changes as the partial extension, but through 2012 rather than permanently.

According to CBO's estimates based on preliminary information provided by the staff of the Joint Committee on Taxation, a full extension of the 2001 and 2003 tax cuts—including indexing the alternative minimum tax for inflation and making various other changes—would reduce federal revenues as a share of GDP by 1.2 percent in 2011 and 1.7 percent in 2012 compared with the amounts projected under current law. A partial extension of those tax cuts—in particular, an extension of all provisions except some that apply to married couples with income of $250,000 or more and single taxpayers with income of $200,000 or more—would reduce revenues by about one-quarter to one-fifth less, amounting to 0.9 percent of GDP in 2011 and 1.4 percent in 2012. If the extension of the tax provisions continued through 2020, the full extension would reduce revenues by 2.1 percent of GDP in that year, and the partial extension would reduce them by 1.6 percent of GDP.

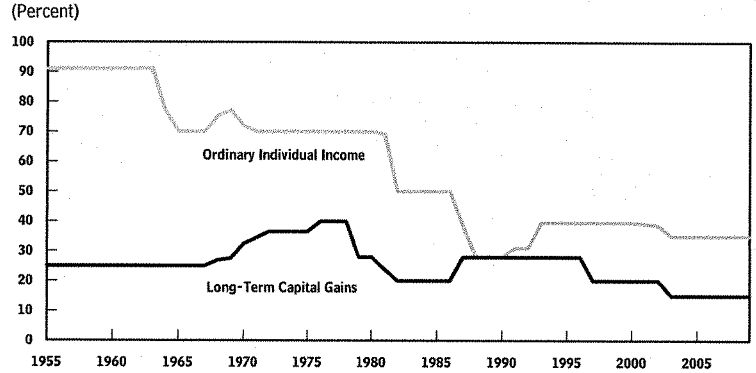
These estimates do not incorporate the impact that the policy options would have on economic activity. Each of the four options examined would increase economic activity during the next two years—but they would also increase federal budget deficits and would probably reduce national income relative to what would otherwise occur by 2020 and in subsequent years.[1] ◆

1. For an analysis quantifying the macroeconomic impact of the four tax policy options, see Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices* (September 28, 2010).

How the Tax System Affects Economic Activity: Marginal Tax Rates and Tax Expenditures

Exhibit 4.

Maximum Statutory Marginal Income Tax Rates on Ordinary Individual Income and Long-Term Capital Gains, 1955 to 2009



Sources: Department of the Treasury, Internal Revenue Service and Office of Tax Analysis.

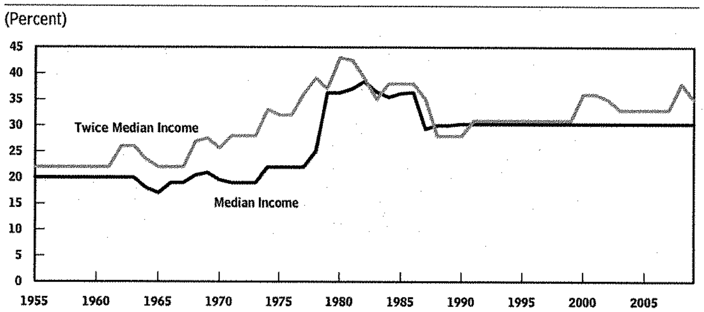
The top statutory marginal income tax rate (the tax rate that applies to the top income tax bracket) has ranged from 28 percent to 39.6 percent in the past 20 years, well below the rates in effect in the preceding decades. In the late 1950s and early 1960s, for example, the top rate was 91 percent. Over time, the maximum rate has applied at different levels of income, and the share of the population affected has varied. For example, the top rate of 70 percent in 1968 applied to roughly 6,000 returns (0.01 percent of the returns filed), whereas the top rate of 35 percent in 2008 applied to almost 1 million returns (0.6 percent of the returns filed).

Different rate schedules have applied to some types of income at different points in time. Since 1955, the maximum rate for long-term capital gains has been lower than that for ordinary income in most years. Other sources of income have been subject to alternative rate schedules for shorter periods. For example, between 1971 and 1986, a lower maximum tax rate applied to earned income, and between 2003 and 2010, dividend income was taxed at a lower maximum rate.

With the expiration of the 2001 and 2003 tax cuts, the top income tax rate for most types of income is scheduled to rise from 35 percent to 39.6 percent in 2011, the top rate on long-term capital gains is scheduled to rise from 15 percent to 20 percent, and dividends will no longer be taxed at a lower maximum rate but will be subject to the same rates as most other income.

Exhibit 5.

Marginal Tax Rates (Income and Payroll) on Earnings for a Family of Four with a Single Earner, 1955 to 2009



Sources: Department of the Treasury, Office of Tax Analysis, and Congressional Budget Office.

The marginal tax rate on earnings is the amount of federal income and payroll taxes that would be collected on an additional dollar earned. For a representative family of four with median income (approximately $75,000 in 2010) and a single earner, the marginal rate has been about 30 percent since 1988, reflecting a marginal income tax rate of 15 percent and a combined payroll tax rate paid by employees and employers that is also about 15 percent. During that time, the marginal tax rate on earnings for a similar family but with twice the median income has fluctuated, averaging about 32 percent—29 percentage points from the income tax and 3 percentage points from the payroll tax (the lower payroll tax rate results from the family's single earner exceeding the maximum taxable threshold for the Social Security payroll tax—$106,800 in 2010). Marginal tax rates for families with less than the median income can vary greatly depending on the characteristics of the family; marginal rates for such families can be higher than that for a median-income family because certain tax credits apply fully for lower-income families but diminish with additional earnings.

The marginal tax rate on earnings for a household with median income climbed sharply in the 1970s primarily because of rising payroll tax rates and inflation, which pushed families into higher income tax brackets. The marginal rate fell when income tax rates were reduced in the Tax Reform Act of 1986 and has stayed at about the same level since then, in part because individual income tax brackets were indexed for inflation starting in 1985. Other estimates, not shown, imply that the marginal tax rate on capital income is currently at the low end of its range during the past half-century. ◆

Exhibit 6.

Estimates of Effective Federal Marginal Tax Rates on Capital and Labor Income Under Current Law and Four Tax Policy Options in 2011, 2012, and 2020

(Percent)

	Capital Income [a]			Labor Income [b]		
	2011	2012	2020	2011	2012	2020
	Effective Federal Marginal Tax Rates					
Rates Under Current Law	15.1	15.5	16.3	30.6	31.1	33.8
	Percentage-Point Change from Current Law					
Full Extension, Permanent	-2.0	-2.1	-2.3	-2.6	-2.7	-3.0
Partial Extension, Permanent	-0.4	-0.4	-0.4	-2.0	-2.0	-2.1
Full Extension, Through 2012	-2.0	-2.1	0	-2.6	-2.7	0
Partial Extension, Through 2012	-0.4	-0.4	0	-2.0	-2.0	0

Source: Congressional Budget Office.

Note: For definitions of the tax policy options examined, see the notes to Exhibit 3.

a. The rate applicable to an additional dollar of capital income subject to federal individual income and corporate income taxes.

b. The rate applicable to an additional dollar of labor income subject to federal individual income and payroll taxes.

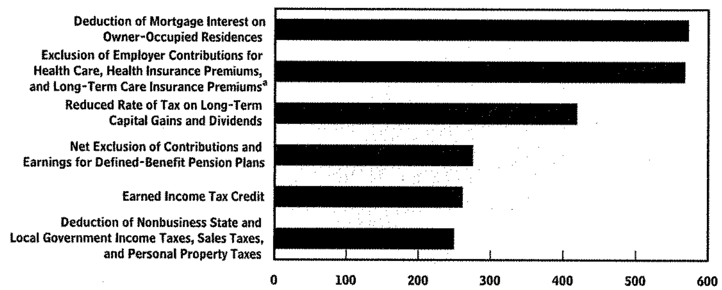
Marginal tax rates can be calculated not just for typical households but also for all capital and labor income in the economy; those rates are often termed "effective" marginal rates because they account for the different tax rates that apply to different types of capital and labor income and for other features of the tax code that can cause marginal rates to be higher or lower than the stated rates in the law. For example, under the corporate income tax, income from some types of investment, such as debt-financed corporate investment and investment in noncorporate businesses, is not taxed. In addition, under the individual income tax, income from some types of investment, such as owner-occupied housing, is not taxed, while income from other types of investment, such as capital gains and dividend income, is taxed at preferential rates. Moreover, some labor income is paid in the form of fringe benefits that are not subject to the individual income tax.

The effective marginal tax rate on capital income is less than the effective marginal tax rate on labor income because a significant portion of capital income is not taxed or is taxed at reduced rates. Under current law, by CBO's estimates, the effective marginal tax rate on capital income, including both the individual income tax and the corporate income tax, will rise from about 13 percent in 2010 to about 15 percent in 2011, as certain tax provisions expire. Under current law, the effective marginal tax rate on labor income, including both the individual income tax and payroll taxes, will rise from about 28 percent in 2010 to about 31 percent in 2011, CBO estimates.

Exhibit 7.

Projections of Forgone Revenues from Selected Individual Income Tax Expenditures, Fiscal Years 2009 to 2013

(Billions of dollars)



Source: Staff of the Joint Committee on Taxation.

a. Estimate does not reflect enactment of the Patient Protection and Affordable Care Act (Public Law 111-148) and the Health Care Education Reconciliation Act of 2010 (P.L. 111-152).

Tax expenditures are the revenues that are forgone because of special exclusions, exemptions or deductions from gross income, special credits, preferential tax rates, or deferrals of tax liabilities aimed at subsidizing certain activities. Tax expenditures reduce the income on which taxes are levied. Therefore, to raise the same amount of revenues, tax rates must be higher than they would be without tax expenditures. Such higher tax rates tend to discourage work and saving.

The two largest tax expenditures—the deduction of mortgage interest on owner-occupied residences and the exclusion of employers' contributions for health insurance premiums—encourage people to buy homes and to take out larger mortgages than they might otherwise be able to afford and encourage employers to compensate employees with contributions toward their health insurance and health care. Together those two tax expenditures are projected to result in $1.1 trillion in forgone revenues over the 2009–2013 period.

Although there are difficulties in adding estimates together and comparing them over time, researchers have estimated that total nonbusiness tax expenditures rose sharply between 1976 and 1985, from 4.2 percent to 6.4 percent of GDP. The amount then dropped relative to GDP between 1985 and 1990 as a result of the Tax Reform Act of 1986 but increased again throughout the 1990s, reaching 6.5 percent of GDP in 2001 before declining again slightly.[1] ◆

1. Those amounts are not shown in Exhibit 7. See Leonard Burman, Eric Toder, and Christopher Geissler, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" Discussion Paper No. 31 (Washington, D.C.: Urban-Brookings Tax Policy Center, December 2008); www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf.

Exhibit 8.

Projections of Forgone Revenues from Selected Individual Income Tax Expenditures Related to Housing, Fiscal Years 2009 to 2013

Tax Expenditure	Percentage of Individual Income Tax Revenues
Deduction for Mortgage Interest on Owner-Occupied Residences	9.3
Deduction for Property Taxes on Real Property	2.0
Exclusion of Capital Gains on Sales of Principal Residences	1.4

Sources: Staff of the Joint Committee on Taxation and Congressional Budget Office.

Homeowners can deduct mortgage interest (up to $1.1 million in total) and property taxes from their income when they compute their tax liability. Over the five years from 2009 through 2013, the revenues forgone from those two tax expenditures are projected to be 9.3 percent and 2.0 percent of individual income tax revenues, respectively. The deductions are effectively a subsidy for mortgage interest and property taxes for taxpayers who itemize their deductions and own rather than rent their homes. Even among those who are able to claim the deductions, the subsidies are larger for individuals who face higher marginal tax rates.

Homeowners can also exclude from taxation as much as $250,000 of any capital gain ($500,000 for a joint return) when they sell their primary residence. The forgone revenues from that tax provision are projected to be 1.4 percent of individual income tax revenues from 2009 through 2013.

The tax code treats investments in owner-occupied housing more favorably than other investments. For example, the owner of a rental house pays taxes on the rental income—net of expenses such as mortgage interest, property taxes, depreciation, and maintenance—and may pay taxes on any capital gain when the house is sold; in contrast, a homeowner who occupies a house, and does not collect any rent, is not required to report the rental value of the home as gross income. Yet the homeowner may still be able to deduct mortgage interest and property taxes and not pay taxes on capital gains when the home is sold. In general, the tax code does not permit deductions for the costs of producing income that is not taxed. ◆

Exhibit 9.

Projections of Forgone Revenues from Selected Individual Income Tax Expenditures Related to Health Insurance and Health Care, Fiscal Years 2009 to 2013

Tax Expenditure	Percentage of Individual Income Tax Revenues
Exclusion of Employer Contributions for Health Care, Health Insurance Premiums, and Long-Term Care Insurance Premiums	9.2 [a]
Exclusion of Medicare Benefits for Hospital Insurance (Part A)	2.7
Exclusion of Medicare Benefits for Supplemental Medical Insurance (Part B)	1.9
Deduction for Medical and Long-Term Care Expenses	1.2

Sources: Staff of the Joint Committee on Taxation and Congressional Budget Office.

Note: Estimates do not reflect enactment of the Patient Protection and Affordable Care Act (Public Law 111-148) and the Health Care Education Reconciliation Act of 2010 (P.L. 111-152).

a. Does not include the exclusion of employer and employee contributions for employer-sponsored health insurance from payroll taxes. Those forgone payroll tax revenues have recently been estimated to be about as large as the forgone individual income tax revenues from the exclusion of employer contributions reported here. See Joint Committee on Taxation, Background Materials for Senate Committee on Finance Roundtable on Health Care Financing," JCX-27-09 (May 8, 2009); www.jct.gov/publications.html?func=startdown&id=3557.

Although employer-paid premiums for health insurance and long-term care insurance are part of employees' total compensation (and are deductible by firms as an expense in calculating their corporate income tax liability), they are exempt from the individual income tax and payroll taxes and are thus excluded from employees' taxable income. The forgone revenues from excluding those premiums (and other employers' contributions for health care) are projected to be 9.2 percent of individual income tax revenues from 2009 through 2013; forgone revenues from payroll taxes will be significant during that period as well.

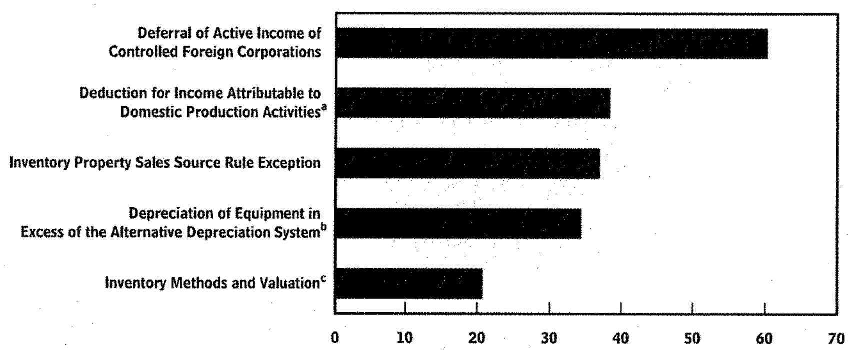
This tax treatment of health insurance has encouraged employers to offer health insurance to their workers and to pay their workers a larger share of their compensation in that form. As a result, people have higher levels of insurance that increase the utilization of health care relative to other forms of consumption; for example, because routine expenses are effectively subsidized, there is an incentive for health insurance plans to cover routine expenses as well as large, unexpected costs, and coverage of routine expenses leads to higher expenses. As with the deductions of mortgage interest and property taxes, the tax-favored treatment of employment-based health insurance represents a subsidy that is larger for individuals who face higher marginal tax rates.

Health care receives favorable tax treatment in other ways. Medicare benefits are excluded from taxable income, and medical expenses and long-term care expenses in excess of a threshold amount can be deducted. ◆

Exhibit 10.

Projections of Forgone Revenues from Selected Corporate Income Tax Expenditures, Fiscal Years 2009 to 2013

(Billions of dollars)



Source: Staff of the Joint Committee on Taxation.

a. There is an additional $15 billion of forgone revenues under the individual income tax.

b. There is an additional $6 billion of forgone revenues under the individual income tax.

c. There is an additional $3 billion of forgone revenues under the individual income tax.

Corporate tax expenditures reduce revenues by much less than individual tax expenditures. The largest corporate tax expenditure—projected to total about $60 billion over the 2009–2013 period—is for the deferral of taxes on active income of controlled foreign corporations. Although the federal government taxes the income that U.S. businesses earn at home or abroad, income earned by a foreign subsidiary of a U.S. multinational corporation is not subject to tax until it is repatriated to the parent corporation as dividends. The deferral of taxes on income earned abroad, which can last indefinitely, favors foreign investments relative to investments at home, but it may also help U.S. companies compete with foreign corporations in international markets.

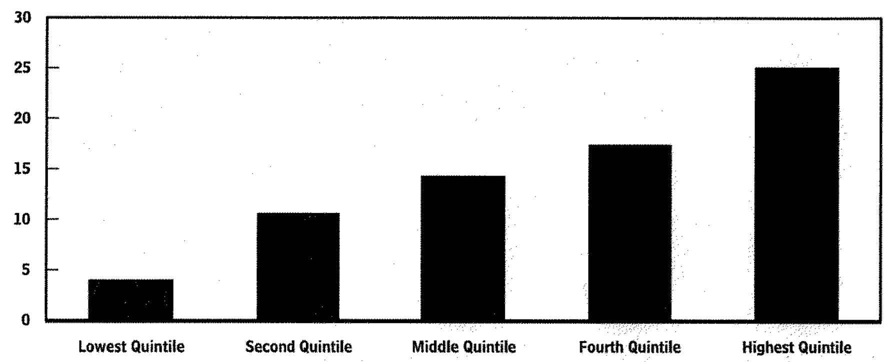
The second largest corporate tax expenditure is the deduction for domestic production activities, projected to result in $38 billion in forgone corporate income tax revenues from 2009 through 2013. U.S. corporations engaged in certain types of domestic production can deduct a percentage of the income earned from those activities (9 percent in most cases) from their taxable income. Lowering taxes on domestic production activities provides an incentive for production at home rather than abroad, but because the deduction does not apply to all domestic production, it favors certain types of domestic production over others. ◆

The Tax Burden and Who Bears It

Exhibit 11.

Average Federal Tax Rates, 2007

(Percent)



Source: Congressional Budget Office.

Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see "Notes and Definitions" at the beginning of this document.

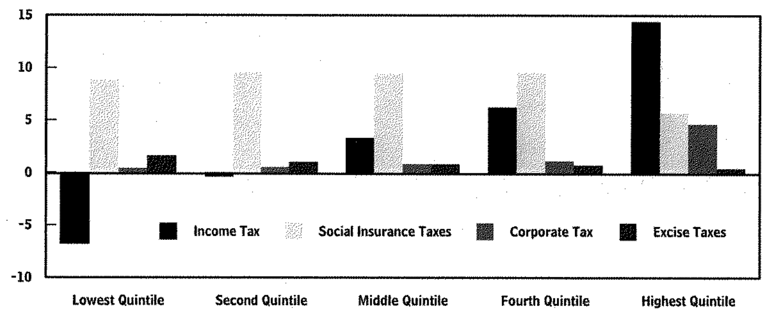
One measure of the tax burden on households is the average tax rate, which equals the taxes paid as a share of income. CBO's estimates of average federal tax rates include not only federal individual income taxes but federal payroll, corporate income, and excise taxes as well. Taxes also impose an additional burden on the economy beyond the taxes paid because they cause taxpayers to alter their economic behavior in ways that generally result in a less efficient allocation of economic resources. That additional burden is not included in the average tax rate measured here.

The overall federal tax system is progressive, which means that average tax rates generally rise with income. In 2007, households in the bottom fifth, or quintile, of the income distribution (with average income of $18,400, under a broad definition of income) paid about 4 percent of their income in federal taxes, while the middle quintile, with average income of $64,500, paid 14 percent, and the highest quintile, with average income of $264,700, paid 25 percent. Average federal tax rates rise within the top quintile: The top 1 percent of households, not shown, faced an average rate of about 30 percent. ◆

Exhibit 12.

Average Federal Tax Rates, by Income Quintile and Tax Source, 2007

(Percent)



Source: Congressional Budget Office.

Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see "Notes and Definitions" at the beginning of this document.

Much of the progressivity of the federal tax system derives from the individual income tax, for which average tax rates rise significantly with income. Average social insurance tax rates are about the same for the second, middle, and fourth income quintiles (and slightly lower for the lowest quintile), but fall significantly for the top quintile because earnings above a threshold are not subject to the Social Security payroll tax and because earnings are a smaller portion of total income for that group. Average corporate tax rates also rise with income, with the largest increase applying to the top quintile, and the average excise tax rate falls as income rises.

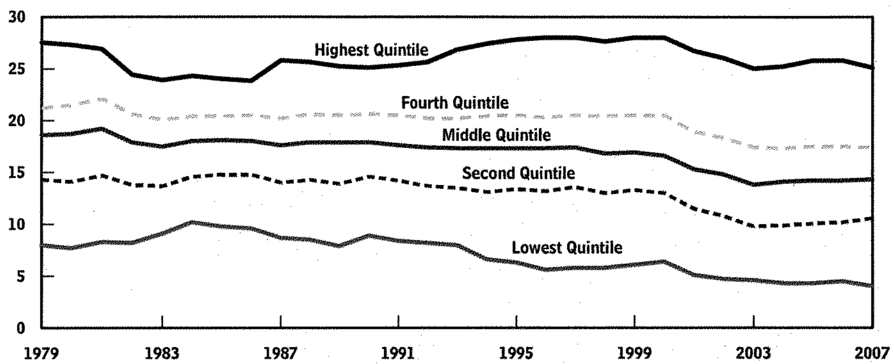
Average social insurance tax rates are higher than the rates for other taxes for all quintiles except the highest, for which the average individual income tax rate is much higher. In other words, on average, people in all quintiles except the highest pay more in payroll taxes (including both the employee's share and the employer's share) than in individual income taxes.

Households bear the burden of corporate income taxes, but the extent to which they bear that burden as corporate shareholders, owners of other types of capital, or workers is not clear. In this analysis, corporate taxes are allocated to households in proportion to their total income from capital. Because higher-income households have a significant share of income from capital, they are estimated to pay a significant portion of the corporate income tax. ◆

Exhibit 13.

Average Federal Tax Rates, by Income Quintile, 1979 to 2007

(Percent)



Source: Congressional Budget Office.

Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see "Notes and Definitions" at the beginning of this document.

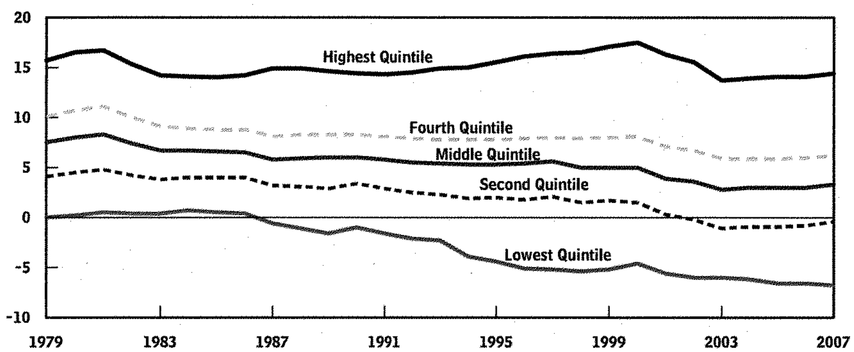
The pattern of average federal tax rates has varied over time. The lowest three income quintiles have seen declines in their average tax rates since the early 1980s. The average tax rate on the fourth quintile changed little over most of the past 30 years, before declining starting about a decade ago. The average tax rate on the top quintile has fluctuated more, with periods of increases and decreases, and was somewhat lower in 2007 than in 1979.

Average federal tax rates on all income quintiles fell noticeably after 2000 as a result of the recession and the tax reductions enacted beginning in 2001.

Exhibit 14.

Average Federal Individual Income Tax Rates, by Income Quintile, 1979 to 2007

(Percent)



Source: Congressional Budget Office.

Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see "Notes and Definitions" at the beginning of this document.

As with the average federal tax rates for all taxes, average federal tax rates for the individual income tax have declined for the lowest three income quintiles since the early 1980s. Average individual income tax rates for the fourth quintile and the top quintile have also declined, on balance, over time. The extent of the decrease was greatest for the lowest quintile, for which the rate dropped by nearly 7 percentage points between 1979 and 2007. The large drop in the average individual income tax rate for the lowest quintile after 1990 primarily reflected increases in the earned income tax credit enacted in 1990 and 1993 and the introduction and expansion of the refundable child tax credit after 1997.

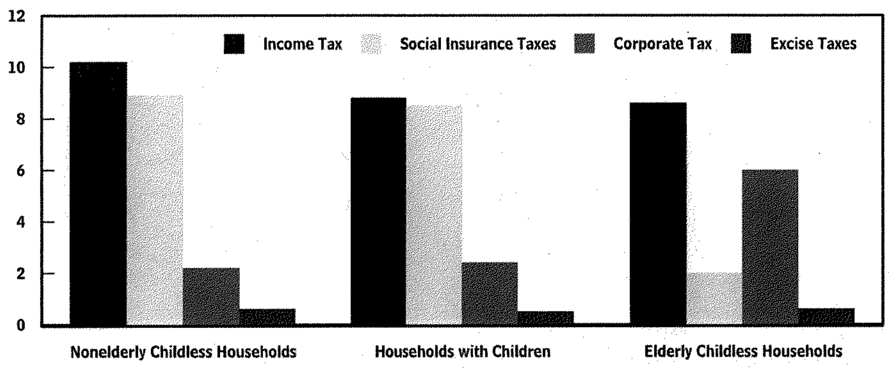
Average tax rates that are less than zero for the bottom two quintiles indicate that, on balance, refundable credits for households in those quintiles exceeded the income taxes they owed before those credits were applied, and thus the households received the excess credits as payments from the Internal Revenue Service.

In 2007, about 35 percent of households did not owe any federal income taxes, although over two-thirds of those households paid federal payroll taxes. About 85 percent of the households that did not pay either income or payroll taxes were elderly households or nonelderly households with income less than $20,000. ◆

Exhibit 15.

Average Federal Tax Rates, by Household Type and Tax Source, 2007

(Percent)



Source: Congressional Budget Office.

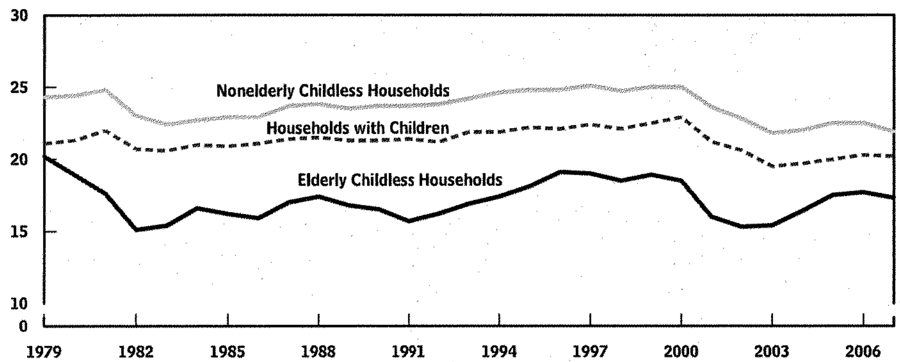
Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see "Notes and Definitions" at the beginning of this document.

Average federal tax rates vary among different types of households because of both tax rules and differences in the amount and nature of household income. In particular, elderly childless households (households headed by someone age 65 or older with no household members under age 18) face much lower average payroll tax burdens than others do because labor earnings are a much smaller part of their household income, but they bear a higher average burden from the corporate income tax because a greater share of their income comes from returns on capital. ◆

Exhibit 16.

Average Federal Tax Rates, by Household Type, 1979 to 2007

(Percent)



Source: Congressional Budget Office.

Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see "Notes and Definitions" at the beginning of this document.

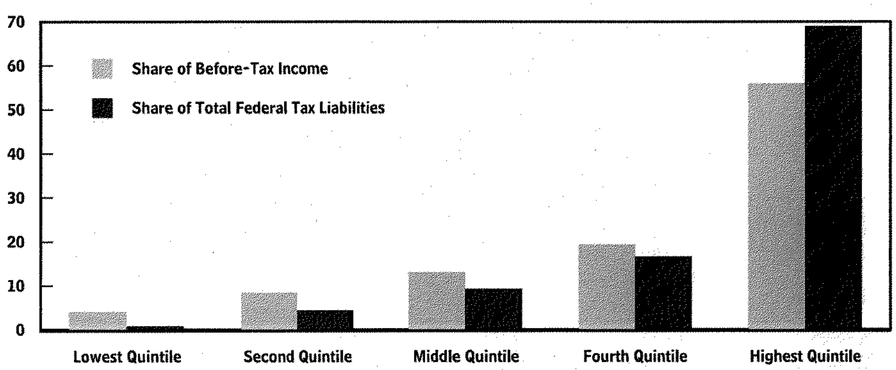
In every year between 1979 and 2007, nonelderly childless households (households headed by someone under age 65 with no household members under age 18) faced the highest average federal tax rates, and elderly childless households faced the lowest average federal tax rates. That difference in tax burden persisted despite a number of changes in tax laws during that period. It reflects both the lower average income for elderly childless households than for other types of households (average tax rates rise with income) and the full or partial exclusion from taxes of Social Security benefits and other income that account for a large share of the total income of elderly households.

Since 1979 the changes in the average federal tax rates paid by households with children (households with at least one household member under age 18) and nonelderly childless households have changed in similar ways; the average rate paid by elderly childless households has shown a different pattern over time.

Exhibit 17.

Shares of Total Before-Tax Income and Total Federal Tax Liabilities, by Income Quintile, 2007

(Percent)



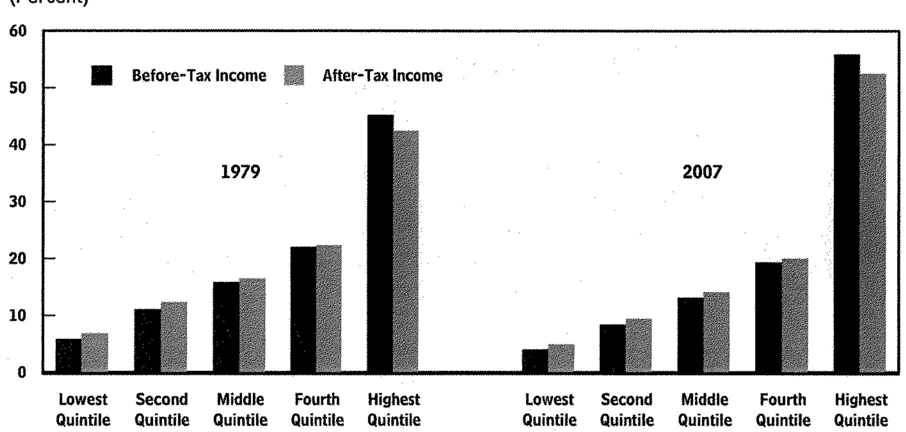
Source: Congressional Budget Office.

Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see "Notes and Definitions" at the beginning of this document.

Another way to describe the distribution of the tax burden is to compare different groups' shares of income before taxes and shares of taxes paid. Higher-income groups earn a disproportionate share of before-tax income; because average federal tax rates rise with income, they pay an even larger share of federal taxes. In 2007, households in the highest quintile earned 55 percent of before-tax income and paid almost 70 percent of federal taxes; for all other quintiles, their share of federal taxes was less than their share of income. The bottom quintile earned 4 percent of income and paid less than 1 percent of federal taxes, while the middle quintile earned 13 percent of income and paid 9 percent of federal taxes. The top 1 percent of households, not shown, earned 19 percent of income and paid 28 percent of federal taxes. ◆

Exhibit 18.

Shares of Before-Tax and After-Tax Income, by Income Quintile, 1979 and 2007



Source: Congressional Budget Office.

After-tax income was distributed more evenly than before-tax income in both 1979 and 2007 because average federal tax rates rise with income. However, the impact of federal taxes on the distribution of income was relatively small in both years. For example, households in the top two quintiles had 68 percent of before-tax income and 65 percent of after-tax income in 1979; those shares were 75 percent and 73 percent, respectively, in 2007.

Between 1979 and 2007, the share of before-tax income fell for each income group except for the highest quintile, whose share increased from 46 percent to 56 percent. (The share of before-tax income for the 1 percent of households with the highest income increased from 9 percent to 19 percent.) Almost all of the changes in the after-tax distribution of income between 1979 and 2007 can be attributed to the changes in the distribution of before-tax income; changes in average tax rates had little impact on the distribution of after-tax income over that period.

Senate Finance Committee Hearing
"Tax Reform: Historical Trends in Income and Revenue"
December 2, 2010
Responses to Questions for Dr. Douglas Elmendorf

Questions from Senator Bill Nelson

1. In a report released yesterday, Goldman Sachs raised its estimates for economic growth in 2011 and 2012, but suggested the greatest risk to the economy remains the housing market. The report states: "On the downside, the risk that worries us most is the potential for a significant renewed drop in home prices to trigger another round of consumer retrenchment. We have been estimating that prices would drop only 2½%-3½% over the next couple of years, but as the passage of time allows us to pin down the effects of the homebuyer tax credit more precisely, we now estimate that prices could drop 5% or a bit more over the next year." Just this week, I proposed a new extension of the homebuyer credit. In your view, what effect would renewing the homebuyer tax credit have on the housing market and the economy?

Response: Extending the homebuyer credit temporarily would likely increase home purchases during the period over which it would be in effect, although many of those purchases likely would be purchases that were retimed to take advantage of the credit and which would have been made anyway. In addition to the direct effect on the housing market, the additional purchases would provide a boost to the rest of the economy, but the total impact on both the housing market and broader economy would be small compared to the impact of other policy actions taken by the federal government and the Federal Reserve.

The first-time homebuyer credit was initially enacted in July 2008 and covered a one-year period. Since then, it has been extended twice – once for the period covering February 2009 through December 2009 and then again in November 2009 for the period through July 2010. That last extension included a smaller credit for existing homeowners who buy a new primary residence.

Estimates of the effects of the credit on purchases of new homes vary greatly. As of August 2009, 1.4 million taxpayers had claimed credits averaging about $7,000 – totaling $10 billion in credits.[1] However, many of those taxpayers might have purchased a home even if the credit was not available. When the credit was extended in February 2009, the National Association of Homebuilders, the National Association of Realtors, and Moody's projected an increase in new home sales of 200,000 to 400,000 through the end of the year. The Congressional Research Service (CRS) subsequently estimated that the rate of response may have been smaller--between 43,000 to 128,000 additional sales over the same number of months. CRS also estimated that the third extension (enacted in November 2009) added

[1] Keightley, Mark, *An Economic Analysis of the Homebuyer Tax Credit*, CRS Report for Congress, July 1, 2010.

about 20 percent more sales than the second extension, in part because that legislation extended eligibility for the credit to existing homeowners.[2]

Further extensions of the credit are likely to have smaller effects on home purchases. Many potential buyers have already responded to the credit, and those that have not may anticipate even further extensions and thus will not accelerate purchases to take advantage of the credit.

The impact of the credit on the housing market is smaller than other actions the government and the Federal Reserve have under way. The federal government continues to encourage home mortgage lending through Fannie Mae, Freddie Mac, and the Federal Housing Administration, and the Federal Reserve is continuing policies that tend to keep mortgage interest rates low. More broadly, the government has taken other steps to stimulate the economy, including enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

2. American consumers are deleveraging, paying down debt, and spending less. In contrast, domestic consumption in many developing countries is on the rise. As a result, our ability to compete in foreign markets is expected to play a major role in our future growth. In your view, do our current international tax rules contribute to export-driven job creation in the United States? Or do the international tax rules discourage domestic job growth?

Response: The tax laws governing multinational corporations and international trade affect labor markets in the United States by affecting firms' incentives to produce and invest domestically. While some provisions of those tax laws encourage firms to produce and invest in other countries, other provisions have the opposite effect. On net, the effect of these tax laws on U.S. labor markets is uncertain.

The tax treatment of foreign income earned by U.S. multinational corporations influences firms' decisions to invest and produce abroad or in the United States. The tax code allows U.S. corporate taxes on income earned abroad to be deferred until that income is remitted back to the United States in the form of dividends. Deferral encourages investment and production overseas, where the income earned from that production can be retained abroad and can escape U.S. tax, potentially indefinitely. It is uncertain, however, how much that deferral encourages U.S. firms to actually move production abroad as opposed to simply shifting income earned from domestic production to foreign jurisdictions. Moreover, foreign operations of U.S. multinational corporations can complement rather than substitute for U.S. operations by, among other things, creating access to foreign customers for products produced in the U.S.

Two other tax provisions tend to encourage production within the United States: the "title passage" rule and the domestic production activities deduction. While the income that U.S. corporations receive from exports typically is not taxed by foreign nations, the U.S. tax

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[2] *Ibid.* One reason that the private sector estimates are higher than CRS's is that they probably include a trade-up effect from the sellers buying another home.

code's title passage rule specifies that, when a firm's inventory is sold, the income from that sale is treated as earned in the country in which the sale occurred—and is subject to that country's tax laws. But if a firm produces its goods within the United States and then sells its inventory abroad as exports, half that income is allocated to the United States and half is governed by the title passage rule and allocated to the jurisdiction in which the sale took place. This exception encourages U.S. firms to produce more goods for exports by keeping them as inventory and selling those goods in low-tax countries. Additionally, the domestic production activities deduction, which allows firms to deduct some of the income from certain forms of domestic production, encourages the production of certain goods in the United States. While some of the qualified activities do not produce goods that are exported, such as electricity and gas production, others, including the production of films, do generate goods that are exported.

3. Since its enactment, a basic foundation of the income tax has been the "ability to pay" principle. Those that can afford to bear a greater share of the tax burden do so. Over the last 30-40 years, income and wealth has been increasingly concentrated at the top end of the income scale, with a hollowing out of the middle class. Presumably, the tax burden should have shifted along with this change in income and wealth distribution. Has this occurred? Has the tax burden shifted at the same rate that income and wealth has become concentrated?

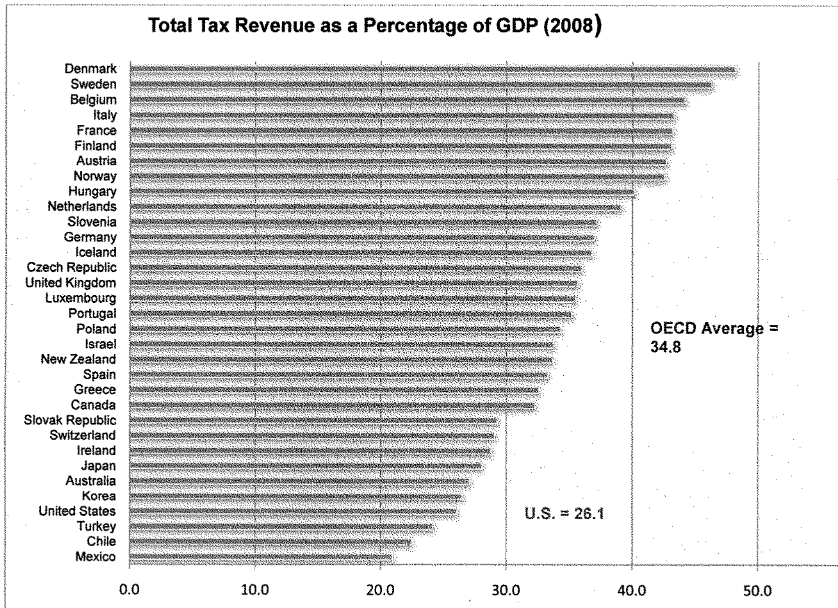
Response: Since 1979, higher income groups have seen more rapid increases in pretax income than lower income groups. Consequently, the shares of income earned and federal taxes paid by higher income groups have increased.

Over the past three decades, the share of income earned by the highest income quintile (the top one-fifth of the population ranked by income) has grown by over ten percentage points. In 1979, the highest quintile earned 46 percent of pretax income; by 2007, they earned 56 percent. Much of that growth is attributable to the top 1 percent of households, who earned 9 percent of pretax income in 1979 and 19 percent in 2007.

Because average tax rates rise with income, higher-income groups pay an even larger share of federal taxes. With their share of income growing at a faster rate than other groups, they have also borne an increasingly larger share of federal taxes. In 1979, the highest income quintile paid 56 percent of total federal taxes (combined federal individual and corporate income taxes, payroll taxes, and excise taxes). By 2007, that share had grown to almost 70 percent. Over the same period, the share of federal taxes paid by the top 1 percent of households rose from 15 percent to 28 percent.

4. At the end of the day, compared to our major trading partners, is the United States a low-tax nation or a high-tax nation? I'm not asking just about income taxes. I'm not even talking just about federal taxes. With respect to the *total tax burden* -- federal, state, and local, how does America come out relative to other countries?

Response: In 2008, taxes – as a share of total gross domestic product (GDP) – were lower in the United States than in nearly all other member counties of the Organisation for Economic Co-Operation and Development (OECD). The following figure compares revenues as a percentage of GDP across OECD countries in 2008, the latest year for which complete information is available for all countries. Taxes include those collected at the federal, state, and local level in the United States and by the corresponding levels of government in other countries. Combined federal, state, and local taxes were 26.1 percent of GDP in the United States, compared with 34.8 percent on average for all OECD countries. Taxes as a percentage of GDP in the U.S. have been below the OECD average for at least the past forty years.[3]



Source: Organisation for Economic Cooperation and Development, *OECD.StatExtracts* (2010)

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[3] "Revenue Statistics - Comparative Tables." *OECD Statistics*. Organisation for Economic Co-operation and Development. Web. 10 Jan. 2011. <http://stats.oecd.org/Index.aspx>.

5. For the typical middle-class family, the last 10 years can be summed up with the following: stagnant or declining real wages; rising health insurance premiums; higher food, energy, and transportation costs; increasingly unaffordable college tuition; decimated 401(k) retirement accounts; underwater mortgages; oppressive and unsustainable credit card debts; and serious doubts that their children will have a higher standard of living than they did. Is there any solid evidence you can cite that demonstrates these struggling middle class families benefited, even on a trickle-down basis, from the 2001 tax cuts that applied to those making more than $1 million a year?

Response: Many economic factors and government policies affect the level and distribution of income across groups in the United States. Isolating the contribution of this particular policy change is a complex and difficult task that we have not undertaken.

Questions from Senator Hatch

1. All of your testimonies are excellent and filled with useful information in terms of how our tax system operates. However, I saw very little in there about the research tax credit. Maybe it is because we have no research credit at the present time. One of my biggest concerns from a competitiveness standpoint is that we as a nation are at risk of losing a great deal of the R&D that is performed in this country because other nations have enacted very generous research tax incentives in an attempt to lure away research from our shores. Do you agree with me that a U.S. temporary research tax credit that is on again and off again with no certainty about its future is far less effective in competing against foreign research tax incentives than a strong permanent research incentive?

Response: The effectiveness of the research and experimentation tax credit in stimulating additional research and development is probably limited by uncertainty about its permanence, an attribute that does not mesh with the (generally) long time horizon of R&D projects. With a temporary tax credit there is uncertainty about whether and when the credit will be extended and with what possible modifications. That uncertainty is not likely to matter much for companies engaged in qualified research projects that take only a short time to complete, but could affect the vast majority of R&D projects with longer-term horizons. The repeated past renewals of the tax credit may give companies somewhat more confidence that it will be renewed again, but making the tax credit permanent would still reduce uncertainty and encourage firms to undertake more long-term R&D projects.

While a permanent R&E credit would increase research expenditures over what they otherwise would be, it is not clear the extent to which the benefits of the additional expenditures would outweigh the benefits of alternative expenditures that could be made with the same resources. Proponents of the credit argue that the increased research expenditures create general knowledge or social benefits that go beyond the benefits that accrue directly to the businesses making the additional expenditures, and thus a subsidy, in the form of the credit, is cost effective for society. However, the credit applies to all additional research an enterprise undertakes, including that which generates no benefits beyond those captured by the firm itself. The portion of the credit that supports private research with no social benefits could instead be used to directly fund research by the government or the nonprofit sector that would generate social benefits. Thus the value of the credit depends upon whether the social benefit of the private research it stimulates exceeds the social value of the benefits foregone by not funding government or nonprofit research.

2. In talking about the progressivity of our federal tax system, which I believe all of you did in your testimonies, you indicate that the federal tax system overall is progressive, but that the income tax component is much more progressive. In other words, the payroll tax and the excise tax components are not nearly as progressive and may even be regressive. My question is this: when talking about the payroll tax component, are you considering the fact that the Social Security system itself, through its benefit structure, is quite progressive in that lower-income workers get back a larger share of their contributions than do higher-income workers? When taking into account the benefits of Social Security, wouldn't the overall tax system be even more progressive than what you are indicating?

Response: The discussion of the progressivity of the federal tax system in CBO's testimony refers only to the distribution of taxes, not the spending financed by those taxes, whether for Social Security benefits or for other federal outlays. The combined distribution of federal taxes and spending would certainly differ from the distribution of taxes alone, although CBO has not analyzed the distribution of all federal spending. The agency has, however, examined the distribution of combined Social Security taxes and benefits and finds that the system as a whole is progressive. The ratio of lifetime Social Security benefits to lifetime payroll taxes for people with lower-than-average lifetime earnings is higher than it is for people with higher-than-average lifetime earnings.[4]

3. Your testimonies discussed the distribution of income and of the tax burden by quintiles of income earners. For example, Dr. Mazur indicated that the share of pre-tax income going to those in the lowest quintile fell from 5.7 percent to 4 percent between 1979 and 2007. I have two questions about this. First, does the pre-tax income of those in this lowest quintile include the various forms of federal, state, and local government assistance they may be receiving? Second, if we were to factor in the tax benefits from the Earned Income Credit and other forms of refundable tax credits, would the data indicate that those in this lowest quintile are doing much better than these pre-tax numbers show?

Response: CBO's pretax income measure includes income from both federal and state transfer programs. That includes cash transfers such as Social Security, Supplemental Security Income, Unemployment Insurance, and welfare benefits, as well as the value of in-kind benefits such as Medicare, Medicaid, food stamps, school lunches and breakfasts, and housing assistance. For transfer payments other than Social Security and unemployment insurance benefits, CBO relies on estimates of participation and benefit amounts from the Census Bureau's Current Population Survey (CPS).

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[4] For more details, see "Is Social Security Progressive" (December 2006), http://www.cbo.gov/ftpdocs/77xx/doc7705/12-15-Progressivity-SS.pdf; and "CBO's 2010 Long-Term Projections for Social Security: Additional Information" (October 2010), http://www.cbo.gov/ftpdocs/119xx/doc11943/10-22-SocialSecurity_chartbook.pdf.

CBO counts the refundable portion of tax credits as negative individual income taxes. They are not included in the agency's measure of pretax income, but instead are counted in CBO's measure of after-tax income. In 2007, the refundable portion of the earned income credit totaled $43 billion, while the refundable portion of the child credit totaled $17 billion, together equal to about 0.6 percent of pretax income. Refundable tax credits are mostly received by households in the bottom two income quintiles.

4. CBO has released estimates of revenues under current law and under the assumption that the expiring tax relief provisions from 2001 and 2003 are extended in various scenarios. For example, the projection on page 7 of Dr. Elmendorf's testimony (Exhibit 3) indicates that revenue as a percentage of GDP would drop in 2012 by 1.7 percent from current law if we extend all the tax relief provisions on a permanent basis. However, Dr. Elmendorf's testimony includes this caveat: "These estimates do not incorporate the impact that the policy options would have on economic activity." This is a pretty big caveat, is it not?

   For example, I read yesterday that a number of economists are warning that if Congress fails to extend the tax relief provisions, there is a very good chance that the economy will go back into recession next year. My question is this: If we do take into account the impact of the policy options on economic activity, wouldn't the effect on revenue loss of extending the tax relief provisions be much less than what CBO is projecting?

Response: The impact on revenues from changes in the level of economic activity that would result from extending the tax reductions would be different in the short and longer run. During the next few years, CBO anticipates that economic activity will continue to be constrained primarily by weak demand for goods and services. Therefore, CBO expects that the lower revenues from extending the tax reductions would increase economic activity by increasing that demand. Over the longer term, however, CBO anticipates that economic activity output will be constrained primarily by the supply of labor and capital. At that horizon, extending the tax reductions would probably reduce economic activity because the negative impact of larger deficits would outweigh the positive impact of lower marginal tax rates. Thus, in the first few years, higher levels of economic activity would likely reduce the revenue loss reported in Exhibit 3, but over the longer term lower levels of economic activity would likely increase the revenue loss reported in Exhibit 3.

In September 28, 2010, testimony before the Senate Budget Committee, CBO estimated that the alternative extensions of tax reductions that were examined would increase gross national product (GNP) by between 0.3 and 1.4 percent of GNP in 2011 and between 0.3 and 1.9 percent in 2012. CBO has not calculated the revenue impact from those changes in GNP. However, under some simplifying assumptions (for example, that all taxable incomes respond proportionally to changes in GNP), the increases in GNP could reduce the revenue losses for 2011 and 2012 shown in Exhibit 3 by between 3 percent and 20 percent.

In that same testimony, CBO estimated that by 2020, the alternative extensions of tax reductions that were examined would reduce GNP relative to what would occur under current law. As a result, the revenue losses would be somewhat larger than those shown in Exhibit 3, but CBO has not calculated those effects.

5. Dr. Elmendorf's testimony indicates on page 2 that "households bear the burden of corporate income taxes, but the extent to which they bear that burden as owners of capital, workers, or consumers is not clear." Is this just another way of saying that corporations don't pay tax, people do?

   Do we have any idea of how progressive the corporate income tax is when considering the fact that its tax burden falls on various households?

Response: People bear the burden of the corporate income tax and of taxes on capital income generally. However, the distribution of that burden across households is uncertain. In the short term, owners of corporate equity bear most of the economic burden of the corporate tax through reduced after-tax profits. Over the longer term, if tax rates on income from different types of assets are not uniform, investment will shift to assets for which the income is taxed at lower rates. Such shifts will lower the before-tax rate of return on those more lightly taxed assets, spreading the economic burden of the tax across all types of capital income. And over the longer term, at least some of the economic burden is probably also be shifted to wage earners. In particular, if saving and investment fall because of the tax, or if the tax causes investment to shift overseas, the domestic capital stock will grow more slowly, reducing workers' productivity and wages relative to what they would otherwise be. However, the degree of such shifting is uncertain.

In its analysis of average tax rates, CBO has assumed that the corporate tax lowers the return to all capital. CBO allocated the tax to owners of capital in proportion to their income from capital, measured as interest, dividends, rents, and adjusted capital gains. Adjusted capital gains are used in place of actual realizations to smooth out large year-to-year variations in the total amount of gains realized. Under that assumption, corporate taxes are quite concentrated at the top of the income distribution, with the highest income quintile paying 87 percent of the corporate tax in 2007. Assuming that more of the tax was borne by corporate shareholders would make the tax burden even more concentrated at the top of the income scale, while assuming that more of the tax was borne by workers would make the tax burden less concentrated.

Questions from Senator Enzi

1. A series of proposals and recommendations have recently been offered to restore the nation's fiscal balance, with tax reform being a significant contributor to such an effort. For example, the final report from the National Commission on Fiscal Responsibility and Reform recommends a move to a territorial tax system as part of reforming the corporate tax structure. Such a move could have a significant impact on the organizational structure and operations of both small and large U.S. multinationals, as well as potentially significant financial statement impacts. Given this, it would be prudent to include appropriate transition rules in any tax reform effort. What should be taken into consideration as part of any transition plan, both with respect to the individual and corporate tax systems?

Response: Special rules may ease the transition from one tax regime to another for both individuals and businesses. One key consideration is the extent to which tax reform would disrupt long-term plans by taxpayers. Transition rules can provide taxpayers with a cushion against those types of disruptions. Transition rules can take various forms – such as delayed effective dates, phasing in of changes, and grandfathering of certain activities.

Many tax reform proposals would broaden the individual and corporate income tax bases while lowering tax rates. Base broadening would subject more income to tax – in some cases by limiting or eliminating certain tax subsidies or incentives known as tax expenditures. Taxpayers often make plans – such as investment decisions – on the expectation that they will benefit from those tax expenditures for a number of years.

Businesses, for example, invest in plant and equipment for the long-term. Those investment decisions often take into account the effect of tax credits on after-tax profits. (Thus, for example, existing credits that support production of alternative fuels, development of fossil fuels and minerals, and low income housing, increase after-tax profits from investments in ethanol plants, oil wells, and certain apartment buildings.) Eliminating or curtailing those credits could lead to financial losses for businesses that had already invested in the tax-preferred activities or sectors. Similarly, firms choose between locating production plants in the United States and other countries based on the tax laws in place here and abroad. Changing the tax treatment of multinational corporations would affect the return from those long-term investments.

Individuals also make long-term investment decisions based on the existing tax code. Changes in tax rates and the deductibility of mortgage interest can increase the after-tax cost of mortgage payments and lower the price of some houses. Homebuyers and existing home owners would need time to adjust their budgets and home purchases to any change.

Fundamental and rapid changes to the tax systems can indirectly disrupt economic activity in other ways. Universities and hospitals, for example, make long-term investments in structures anticipating a flow of charitable contributions from donors; changes in the tax incentives for charitable contributions can affect the flow of contributions and thereby the appropriate long-term investment decisions. Similarly, state and local governments plan projects based on assumptions regarding future sales of tax-exempt bonds. Unanticipated changes to the tax treatment of charitable giving or municipal bonds could make it difficult for charities and state and local governments to maintain those investment plans.

In short, major changes in tax expenditures and tax rates will affect long-term decisions throughout the economy. More time for business, individuals, governments, and nonprofits to adjust to the changes can lead to a more efficient and less economically disruptive transition.

2. A common complaint of taxpayers is that the current income tax system is overly-complex, and complying with the rules and requirements of the Internal Revenue Code and its thousands of pages of regulations is costly and burdensome. Many proposals have been offered identifying how Congress might approach changes to the tax system for the purpose of simplifying and streamlining the tax laws. What are the considerations of undertaking such an effort both within and outside the context of deficit/debt reduction? How might the effects of such changes be more pronounced for certain taxpayers? How might such changes impact the "tax gap?"

Response: One measure of complexity is the costs incurred by taxpayers complying with the tax code. In 2005, the Treasury Department estimated that individuals and businesses spend about $140 billion a year complying with the federal income tax. Those costs include out-of-pocket expenses on such items as paid preparers and software, as well as the value of taxpayers' own time spent on tax preparation (from learning the tax law to gathering records to completing and submitting returns). The monetary estimates of compliance costs do not include other intangible costs associated with preparing tax returns – such as the anxiety many taxpayers feel when determining their tax liability and interacting with the Internal Revenue Service.

The complexity of the tax code affects individuals throughout the income distribution. By requiring taxpayers to compute their tax liability twice, the alternative minimum tax (AMT) imposes compliance burdens on high-income taxpayers (and even some middle-income taxpayers). Phaseouts of the personal exemption, the child tax credit, and the education tax credits make middle-income taxpayers complete additional worksheets to determine the value of those tax provisions. Subtly different eligibility rules for two child-related tax credits – the earned income tax credit (EITC) and the refundable portion of the child tax credit – make tax-filing more complicated for many low-income working parents who could be eligible for one, both, or neither credit.

Because complexity pervades the income distribution, simplifying the tax code could have beneficial effects for many different groups of taxpayers. The distribution of those benefits, though, depends on the specific design of a simplification package. Changes to the AMT clearly affect a different group of taxpayers than modifications of refundable tax credits.

Reducing compliance burdens may also affect the achievement of other tax and social policy goals, in some cases reinforcing those goals but in other cases requiring trade-offs. Eliminating phaseouts of the personal exemption and various tax credits, as noted above, would reduce taxpayers' compliance burdens. Economic efficiency would also improve, because marginal tax rates would decline, thus increasing incentives to work and to save. However, extending those tax benefits to families at higher incomes levels would substantially increase the budget deficit.

Similarly, reducing compliance burdens can have both positive and negative effects on tax administration and tax compliance. Some simplification proposals make it easier both for taxpayers to understand the tax code and for the IRS to enforce it. Changes in tax law that make it easier for taxpayers to sustain a claim on their tax returns can reduce both compliance burdens and the tax gap. That was the motivation, in part, for the creation of a "uniform definition of a child" under the Working Families Tax Relief Act of 2004; by replacing a complicated support test with a simpler residency requirement, the new legislation was supposed to make it easier for taxpayers to claim certain child-related tax benefits and for the IRS to verify eligibility.

Other types of simplification proposals, however, could increase noncompliance. Under current law, individuals and businesses are often required to provide the IRS with information regarding payments to another taxpayer. Generally, compliance is highest when income is subject to withholding and reliable third-party reporting (e.g., wage income), and it is lowest when neither of those conditions is met (e.g., income from self-employment). Reducing reporting requirements would lower the compliance burdens for some taxpayers (the ones required to make those reports), but would also make it more difficult (and costly) for the IRS to verify claims of income by other taxpayers (the ones who receive the payments). As a consequence, noncompliance could increase if third-party reporting requirements were dropped.

3. It's been offered that tax expenditures have the effect of altering individuals' and companies' economic behavior, which might lead to less-than-optimal resource allocations. On the one hand, the final report from the National Commission on Fiscal Responsibility and Reform recommended eliminating nearly all tax expenditures and reducing income tax rates, the effect of which would lessen such distortions. On the other hand, Martin Feldstein suggested in a recent Washington Post article implementing rules to cap the benefit taxpayers receive from the combined effect of different tax expenditures (with no reduction in the types or numbers of tax expenditures). To what extent would this proposal have an effect on economic behavior and efficient resource allocation? Just as important, what might the impact of this type of proposal have on simplifying the tax laws and streamlining their administration?

Response: Tax expenditures are the revenues that are forgone because of special exclusions, exemptions or deductions from gross income, special credits, preferential tax rates, or deferrals of tax liabilities aimed at subsidizing certain activities. Tax expenditures typically reduce the income on which taxes are levied, but also can directly reduce tax liabilities. Therefore, to raise the same amount of revenues, tax rates must be higher than they would be without tax expenditures. Such higher tax rates tend to discourage work and saving.

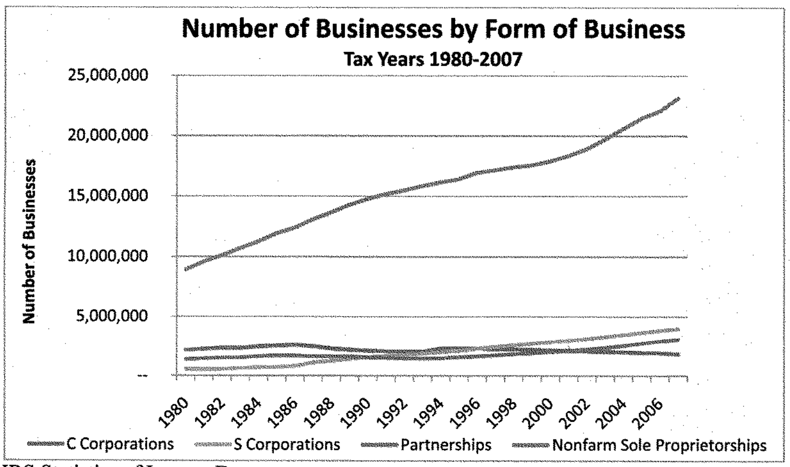
Reducing or eliminating tax expenditures would generally lead to more efficient resource allocation as relative prices for goods and services in the economy would more closely reflect the underlying supply and demand for them. In addition, to the extent that the additional revenue raised from reducing or eliminating tax expenditures was used to lower marginal tax rates, there would be a positive impact on the level of economic activity because lower marginal tax rates would encourage the supply of labor and investment.

Changes in tax expenditures could increase or decrease the burden of complying with and enforcing the tax laws depending upon the particular proposal being examined. For example, eliminating the tax credit for child and dependent care could simplify auditing and reporting requirements for individual income tax returns. At the same time, however, it could potentially make it more difficult to enforce the reporting of income by some child care providers because under current law, child care expenses claimed on tax returns can be traced to income of the recipients. Eliminating tax expenditures that effectively exclude certain types of income, such as needs-based assistance paid by federal and state governments to individuals and families, would mean additional reporting requirements for states, more tax returns filed by low-income people, and greater pressures on the IRS to verify those amounts. Alternatively, eliminating some special credits and deductions – such as the tax credits for higher education expenses – would decrease the burden for taxpayers of complying with the law and lower the costs of tax administration.

Questions from Senator Snowe

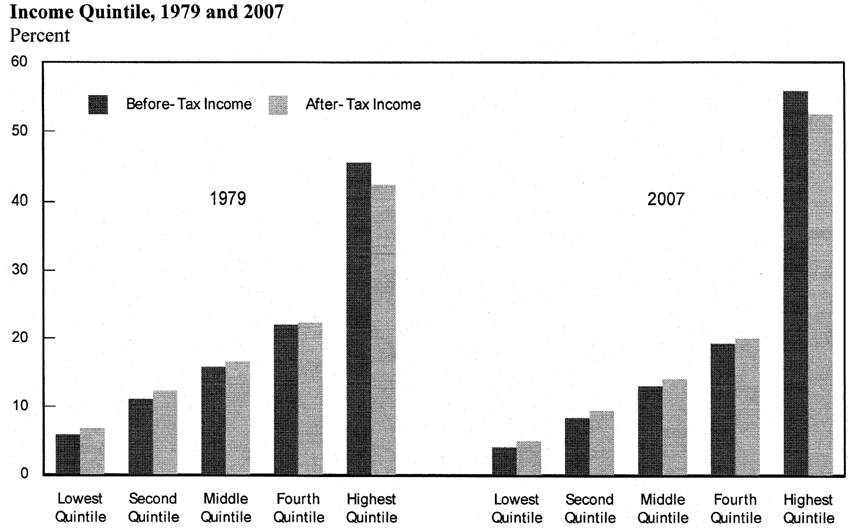
1. I would like to hear from each of our witnesses about the juxtaposition of two sets of data presented today. (charts below) The CBO testimony indicates that there has been a dramatic increase in wealth reported in the top income quintile – this statistic is often reported as a "the rich are getting richer and the poor are getting poorer." Separately, we have heard testimony that there has also been a dramatic rise in the number of sole proprietorships, S Corps and partnerships. The Joint Committee has stated that 50 percent of all income in this upper bracket is attributable to flow-throughs.

   Given the juxtaposition of the rise in number of businesses that are taxed at the individual rates and the rise in wealth in that bracket, it would appear to me that much of that income is actually small business income that is taxed at the top two rates. Small businesses depend upon reinvested profits as the most significant and most accessible source of capital so it is vital to small business well being that we are cautious about raising taxes that send these funds to Washington rather than to reinvestment. **So, I would like to know from the witnesses how much of that rise in wealth is really the result of the greater number of flow-through entrepreneurial establishments that are reporting business income?**



IRS Statistics of Income Data

Exhibit 18: **Shares of Before-Tax and After-Tax Income, by Income Quintile, 1979 and 2007**



CBO Testimony

Response: Business income has been an especially fast-growing income source for the highest income households. Amongst the top percentile of households, business income – income from sole proprietorships, S-Corporations, and partnerships – grew as a share of income from 13 percent to 17 percent between 1979 and 2007. The share of households within the top percentile reporting any income from those activities also grew, from roughly two-thirds to three-quarters. However, it is difficult to draw conclusions about the number of business entities from household-level statistics, since individuals may own multiple entities, and a single entity can have multiple owners, including other business entities. Additionally, changes in the tax law that reduced individual income tax rates may have led some business owners to structure their businesses as pass-through entities rather than C-Corporations. The observed increase in business income over this period may in part reflect a recharacterization of income that previously would have come from corporate dividend income and capital gains from the sale of corporate stock.

2. The growth in the number of flow-through businesses is critical to understanding why the increase in individual rates is so damaging to small business job generation. There has been tremendous growth in the number of sole proprietorships since 1980. Since 1997, there have been more S Corporations than C Corporations.

   In April 2009, the Small Business Administration Office of Advocacy released a study titled Effective Tax Rates Faced by Small Businesses. I believe this is a unique study of this issue and it found that, for the particular subset of small businesses in the study, that the effective tax rate for the year 2004 was 19.8 percent. By each entity type the rates were:

- 13.3 percent for sole proprietorships (non-farm)
- 23.6 percent for small partnerships
- **26.9 percent for small S Corporations**
- 17.5 percent for small C Corporation (additional tax on distributions)

Unfortunately, the subset of businesses in the study was those with less than $10 million of assets, so it limits some of the utility of this data regarding businesses such as construction contractors and manufacturers that would otherwise still be considered "small businesses" but have large amounts of assets.

As experts in the field of tax policy data, do you have a general sense of the definition of "small business" in the tax context is measured by number of employees or by gross receipts tests? In what contexts have you seen an assets threshold used to determine small business?

Would it be possible for the Joint Committee on Taxation to review this SBA study (which I understand was performed by a former Joint Tax staffer) and determine whether the data could be replicated with a different classification, such as by gross receipts, and also for more recent data than for 2004?

Response: Various provisions of the tax code rely on different definitions of a small business. In most cases, the size of the business (determined by the number of employees, the level of gross receipts, or the level of assets) is only one factor in determining eligibility for tax relief. Provisions of the tax code that have size-based eligibility criteria are much more likely to use number of employees or gross receipts as the measure of size than they are to use assets. The specific thresholds, however, vary from provision to provision.

For example, a threshold of $5,000,000 of gross receipts is used for several provisions. That threshold determines which start-up firms are exempt from the corporate alternative minimum tax (AMT) in their first three years, and which firms are allowed to use cash accounting and simplified LIFO inventory accounting. Thresholds of $1,000,000 and $7,500,000 are also used—the former for a credit covering the costs of complying with the Americans with Disabilities Act, and the latter for exemption from the corporate AMT after a firm has been in existence for three years. Other tax provisions that distinguish among businesses of different sizes rely on different gross receipt thresholds.

Thresholds based on the number of employees also vary from provision to provision. The thresholds range from 10 employees (for full eligibility for the new credit covering 35 percent of employer-provided health insurance), to 100 employees (for the credit covering 50 percent of the first $1,000 of the cost of administering and publicizing a pension plan).

One provision that explicitly defines eligibility based on assets is a provision that allows individuals and pass-through entities to exclude 50 percent of any gain from the sale or exchange of qualified small business stock (60 percent if the qualified corporation is based in an empowerment zone). Among the various restrictions on eligibility for that exclusion is that the assets of the qualified corporation cannot exceed $50 million immediately before or after the stock was issued.

3. The income tax code is progressive, in that it provides a lower rate of tax on lower income people and higher taxes on upper income people. In 2006, we have been told the two bottom quintiles actually had a negative tax rate so that people with incomes under $34,000 received back more from the income tax system than they paid. The wealthiest income quintile had a 14 percent effective tax rate while the richest 1 percent had the highest tax rate of 18.9 percent. Policymakers can argue about whether these are appropriate levels of tax, but they are certainly progressive.

Federal Average Tax Rate for Households by Income Level

Household Income Level	Average Income	Average Effective Tax Rate			
	2006	1980	1990	2000	2006
Lowest Quintile	$14,800	0.2	-1.0	-4.6	-6.6
Second Quintile	$34,100	4.5	3.4	1.5	-0.8
Middle Quintile	$51,900	8.0	6.0	5.0	3.0
Fourth Quintile	$77,300	10.7	8.3	8.1	6.0
Highest Quintile	$184,500	16.5	14.4	17.5	14.1
Top 10 %	$260,000	18.2	16.0	19.7	15.9
Top 5 %	$377,300	19.7	17.5	21.6	17.4
Top 1 %	$1,022,400	22.3	19.9	24.2	18.9

See http://www.cbo.gov/publications/collections/tax/2010/average_rates.pdf

Clearly the recession and other tax incentives from the stimulus have changed the distribution of taxes since 2006, according to Dr. Elmendorf's testimony, and knowing the current state of play is going to be essential to good policy making regarding long term tax rates. **How soon can we get data about effective tax rates for the years 2007 through 2010? If there is data available for any of those years can you please provide this?**

Response: CBO's estimates of the distribution and income and taxes are based on data from income tax returns, which are available only with a significant lag. We anticipate updating our series, which currently runs through 2007, with estimates from 2008 this spring. Estimates for 2010 will not be available for some time. Taxpayers have not yet filed tax returns reflecting income earned in 2010. While many taxpayers will file their 2010 returns by April of this year, some will receive extensions from the normal filing deadline and not file until the fall of 2011. It then takes IRS some time to draw a representative sample and comprehensively edit the data, and for CBO to conduct its analysis, so comprehensive statistics on income earned in 2010 will not be available any earlier than late 2012.

While the distribution of income in recent years is not yet known, the parameters of the tax system are known. It would be possible to estimate the impact of any changes in tax provisions after 2007 on average tax rates using income projected through 2010, but CBO has not done that analysis.

Question from Senator Grassley

1. In Keynesian terms, stimulus is usually regarded as i) temporary, and ii) aimed at getting money to people who will most likely spend it, thus stimulating demand. That is, Keynesian economics can be thought of as "demand-side" economics. "Supply-side" economics, on the other hand, is targeted at creating incentives to create additional supply. We usually think of supply-side economics in terms of creating long-term incentives to save and invest. Accordingly, it would seem that demand-side or Keynesian tax policy would be oriented to getting money to people in lower-income brackets, and only for a temporary period. On the other hand, supply-side economics would suggest that tax-cuts should be aimed at getting higher-income tax brackets reduced, and for a permanent period of time. Assuming that there is some legitimacy to both Keynesian and supply-side economics, and that both have something useful to say about tax policy, wouldn't this suggest that if any tax-cuts are to be temporary, it should be the lower-income ones, and if any are to be permanent, it should be the upper-income ones?

Response: Permanent changes to the tax system involve decisions about both the total amount of revenues required to fund the government's outlays on an ongoing basis and the specific tax policies used to raise those revenues. The choice of the total amount of revenue depends on the amount of spending that policymakers determine to be desirable, given the direct and indirect costs of raising the revenue to pay for that spending, as well as the desired long-run level of the budget deficit (which also carries costs). That total revenue could be raised by many different tax policies. A variety of concerns may enter into policymakers' choice of those policies, including the "supply-side" effects of the policy on economic output, general economic efficiency, fairness, and simplicity, among many others.

Under certain economic conditions, such as a persistent gap between actual and potential output, policymakers may choose to enact tax and spending policies to stimulate the economy by increasing the total amount of goods and services purchased by the private sector and the government (i.e., through "demand-side" effects). In general, those policies tend to be most efficient, in terms of stimulative effect per dollar of budgetary cost (or "bang for the buck"), if they are temporary, in part because the economic dislocation being addressed is also likely temporary. In addition, temporary tax reductions tend to provide more bang for the buck if a higher proportion of revenue losses is directed to lower-income households, because they are more likely to spend out of temporary increases in after-tax income. However, there are many considerations to balance in the design of stimulative fiscal policies beyond the bang for the buck, including targeting those most affected by the economic turndown, addressing perceived long-term spending needs, and including a mixture of policies to dilute uncertainty about the effects of any particular policy, among many others.

In testimony before the Senate Budget Committee, CBO presented a more specific analysis that incorporated some of those general principles. Table 1 in that testimony shows CBO's estimates of the effects of a number of temporary tax and spending policies on output and employment per dollar of budgetary cost.

The same testimony also included analysis of the short-term (primarily demand-side) and long-term (supply-side) effects of four tax policies. Those policies included "full extension" of expiring tax cuts, either for two years or permanently, and "partial extension" of expiring tax cuts—that is, excluding some taxes on higher levels of income—also either for two years or permanently. A higher proportion of the revenue losses under the "partial extension" options flows to lower-income households.

CBO's analysis found that permanent extension (under either the "full" or "partial" option) tended to raise output and reduce unemployment by greater amounts in the first two years than did temporary extension, because many households change their consumption by more in response to permanent change in income than they do to a temporary one (see Table 2 of that testimony).

In the long run, however, permanent extension (under either the "full" or "partial" option) tended to reduce output by more than temporary extension (see Table 3 of that testimony). Permanent extension, holding other policies unchanged, implies a larger effect on the deficit and therefore more crowding out of productive capital. CBO estimated that, in the long run, that negative effect tended to outweigh the positive effect of lower marginal tax rates encouraging work and private saving.

Full extension (whether permanent or temporary) also tended to raise output by more than partial extension in the first two years, because it had a greater total effect on after-tax incomes. However, partial extension had a greater short-run economic effect per dollar of revenue loss because a greater proportion of that loss flowed to lower-income households who tend to spend more out of changes in income. In the long run, full extension could reduce output by either more or less than partial extension, depending on the model and assumptions used, CBO's analysis found. The relative magnitude of the effects of full versus partial extension is uncertain because of the offsetting effects of crowding out and reduced marginal tax rates (both of which are greater under full extension).

United States Senate — *Sen. Chuck Grassley · Iowa*
Committee on Finance — *Ranking Member*

Opening Statement of U.S. Senator Chuck Grassley
Ranking Member, Senate Committee on Finance
Tax Reform: Historical Trends in Income and Revenue
Thursday, December 1, 2010

Mr. Chairman, thank you for having this hearing today. With so many extremely important tax matters before Congress, it is good to take a step back, and think about tax policy broadly. When I use the term "tax reform," I mean that term to be revenue neutral. Tax reform to me means a restructuring of the tax Code so as to decrease inefficiencies and decrease complexity – it does not mean a grab of more revenue by the Federal government. So, revenue neutrality means setting a target of revenue that ties to current tax policy.

Why do we not like high taxes?

One is that the economy is growing globally outward. The Fortune 500 is no longer almost completely comprised of US companies. US companies now must compete with foreign companies. Thus, if average tax rates that US-headquartered companies are subject to are higher than the average tax rates of foreign-headquartered companies, we shouldn't be surprised to find that fewer and fewer global businesses are headquartered in the US. Furthermore, if the marginal tax rate that a US business has is higher than that of a foreign business, we would find that the cost-of-capital for US businesses would be higher than for foreign businesses, putting the US businesses at a competitive disadvantage.

From those conclusions regarding America's position in the global economy, it follows that efforts to reduce complexity and tax burdens on flow-through businesses need to be enhanced not reversed. Most of the business growth since the 1986 ACT has been in the flow-through sector. Raising marginal rates and applying complex business tax rules to this sector will retard that growth.

Not only can high taxes fund a too large Federal government, but also that they harm the private sector and make the free market not so free. Income taxes create a disincentive from earning taxable income, thus distorting decision-making and stifling the economy. I believe this to be true no matter what level of taxation there is.

Yes, some minimum level of revenue is necessary for the Federal Government. And, so, some minimum level of taxation is necessary. But to raise a given amount of revenue, there are very harmful ways to raise it, and, on the other hand, there are ways that only cause minimal harm to the free market.

Statistics showing what the average tax rate is for a given set of taxpayers are important. Even more important are the marginal tax rates. Marginal tax rates show what a taxpayer will pay on the next dollar of income. Most decisions are made "on the margin." That is, generally taxpayers will not decide, in response to high taxes, to simply not work. (Admittedly, that does happen some – especially in the case of a spouse rejoining the workforce.) Most people need income, and thus most people need to work.

But, what is common, is making the decision whether to do an extra, or marginal, amount more of work, to make marginally more income. Too high a marginal tax rate can disincentivize work.

It's fundamental to understand this. But yet, back in July of this year, this Committee had before it a witness who was OK with the idea of a 90 percent marginal tax rate. He was of the opinion that since such a taxpayer could keep 10 percent of the return on his effort, it was still worth his while to make the effort. But that's nonsense – if one can only keep 10 cents for every dollar of income, a person will probably decide that he doesn't need the additional income after all, and maybe it's just a good time to take vacation. Or, instead of earning additional taxable income to, say, hire contractors to build a garage next to your house, high marginal rates can lead you to instead build the garage yourself.

Let's hypothetically suppose that a flat income tax with a 20 percent tax rate raised sufficient revenue for the government. Of course, such a flat rate structure could be made progressive by getting rid of the flat 20 percent rate and instead having a 10 percent tax rate for taxable income below some given amount, and a 30 percent tax rate for taxable income above such amount. Note that for people making a low-enough income, their marginal tax rate would be 10 percent, rather than 20 percent. This would increase such persons' incentives to make additional income. However, for higher income people, they would find their incentive to earn more money has gone down. That is, their marginal tax rate would no longer be 20 percent, but would be 30 percent.

So, it may seem that the two sets of rate structure net out. That is, under the progressive rate structure with tax rates of 30 percent and 10 percent, some taxpayers have more incentive, as compared with the 20 percent flat tax, to make additional income, but others would have less incentive. As far as the incentive effects to earn additional income, the two rate structures may "net out."

But that's not telling the full picture.

The full picture is this: Many taxpayers who would be in the 30 percent tax bracket have income that they don't need to have. That is optional. They have their needs met without additional income, so may easily decide to not earn more. Of course, for lower-income workers, they often need the additional money, and so a lower marginal rate (10 percent instead of 20 percent) does not as much encourage additional work, because they likely already wanted and needed additional income.

On a related point, on July 14, this Committee held a "kick-off" tax-reform. At that hearing, I spoke about a taxpayer named John, a real-world case, where John had a high marginal rate of 30 percent, but actually paid no tax at all, and even received a small check from the government. That is, John had a high disincentive from making additional income, but the government got no money from John – the worst of both worlds.

One final word, Mr. Chairman. When it comes to the topic of tax reform, we will inevitably hear a lot of statistics. That's good and proper, given the subject matter. However, it is also worth keeping in mind what the great Conservative leader, Benjamin Disraeli, had to say on this topic. He said: "There are three kinds of lies: Lies, Damned Lies, and Statistics." That's worth keeping in mind with a lot of statistics we will undoubtedly hear re tax reform.

In particular, the United States has changed demographically. There are fewer joint filer households and many more singles and head of households. That demographic change has tended to make joint filers look "richer" than they otherwise would simply because of the mechanics of the measurement. As a result, we get a lot of studies showing a growing income gap with no accounting for this demographic shift.

Thank you, Mr. Chairman.

Testimony of Deputy Assistant Treasury Secretary for Tax Analysis
Dr. Mark J. Mazur
Before the U.S. Senate Committee on Finance
on Tax Reform: Historical Trends in Income and Revenue

Thank you for inviting me to discuss the ever-evolving U.S. tax system. I want to discuss how the economy and the tax system have changed over the last 30 years, focusing on those issues particularly relevant for consideration of tax reform. I believe this discussion will illustrate a number of important issues that should be addressed in any serious tax reform effort, even if specific policy solutions are not immediately clear from the discussion.

Changes in the United States and World Economies

Let me start by highlighting several developments over the past few decades that help frame how we should view the U.S. tax system as it exists today.

One important theme of the past thirty years is that the United States has been and remains a dominant force in the world economy. For example, according to IMF data, the U.S. produced about 26 percent of total world output in 1980 and about the same proportion in 2010, with only minor year-to-year fluctuations (see Table 1). Furthermore, the U.S. economy remains by far the largest in the world, despite the well-publicized economic growth occurring in other countries.

Over the past three decades, however, there have been important worldwide macro-economic changes. One is the growth of so called "emerging market" economies, which include China and India. Emerging markets accounted for about 13 percent of world Gross Domestic Product (GDP) in 1980 and about 22 percent in 2010 (see Table 1). So called "developing countries," which include most of the countries of Latin America and the Middle East, also have grown in importance in recent years: their share of world GDP has increased from about 17 percent in 1980 to about 28 percent in 2010.

A second important development is the increased integration of the world economy. Long-distance communication is now much easier and cheaper than it was thirty years ago. Computers are much cheaper and much faster, and cell phones are ubiquitous. Importantly, international trade in goods and services is now more important than it once was, for the world and for the United States. In the United States, for example, the traded sector (exports plus imports) has grown from 20 percent of GDP in 1980 to 24 percent in 2009, but the most dramatic changes have occurred in emerging economies, such as China and India, where it more than doubled. Over the same period, cross border investment (both direct and portfolio investment) has also become significantly more important. For example, U.S. cross border foreign direct investment (FDI) in stocks has increased from about 11 percent of GDP in 1980 to about 55 percent of GDP in 2009. In the other G-7 countries, cross border FDI in stocks has increased from 10 percent of GDP to 65 percent of GDP over the same period.

A third development in recent years is the increasing share of total income that is earned by the most well-off Americans. As illustrated in Table 2, in 1980, families in the lowest income quintile received 5.7 percent of total income before taxes and those in the highest income quintile received 45.8 percent, while the top 1 percent of families received 9.1 percent of total pre-tax income. By 2007, the bottom quintile received only 4 percent of total pre-tax income, the top quintile received 55.9 percent and the top 1 percent of American families received 19.4 percent of total pre-tax income. This trend is even more striking when one examines IRS data on the top 0.1 percent of the income distribution and/or the 400 taxpayers with the highest Adjusted Gross Incomes (AGIs).

A fourth important economic development in the United States is the sustained growth of "pass-through" businesses. Pass-through businesses are not subject to the separate, entity-level corporate income tax, and include business organized as sole proprietorships, partnerships, and S corporations. According to IRS data (see Table 3), in 2007, 47 percent of total business income in the United States was earned by pass-throughs and 94 percent of all U.S. businesses were pass-throughs. By comparison, in 1980, pass-throughs earned about 21 percent of business income and accounted for about 83 percent of all businesses. According to data from the OECD, pass-through businesses are more prevalent in the United States than they are in other developed countries. This is especially true for large pass-throughs: 66 percent of U.S. businesses reporting a profit of over $1 million were pass-throughs, compared to 27 percent for Mexico, the country with the next largest share (U.S. Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper*, July 26, 2007, pp. 21 – 22).

Finally, there is a large difference in the U.S. Federal government's budget outlook in 2010, compared to that in 1980. During the 1980s, revenues averaged 18.3 percent of GDP, spending averaged 22.2 percent and the deficit averaged 3.9 percent of GDP. In contrast, from FY1998 to FY2001 the Federal budget was in surplus, with revenues averaging 20 percent of GDP and spending 18.5 percent. The 2001 and 2003 tax cuts pushed the Federal budget back into deficit, when combined with increased defense and non-defense spending. As the economy recovers from the recent recession, the FY 2011 Budget projects that the deficit will average about 3.8 percent of GDP over the 2013 to 2019 time frame. Over this period, the FY 2011 Budget projects that Federal revenues will average just over 19 percent of GDP.

I will now turn to specific developments with respect to the U.S. tax system over the last 30 years.

Changes in the United States Tax Systems

The U.S. Federal government now collects revenue using a different mix of taxes and receipts than it did 30 years ago (see Table 4). The individual income tax remains the largest source of receipts, but its share has fallen, from around 47 percent in the early-to-mid 1980s to around 44 percent over the past few years. In recent years, payroll taxes have accounted for a larger share of total receipts—37 percent—than they did in the early to mid 1980s—33 percent, essentially matching the decline in the share of individual income tax revenues. Corporate income tax receipts vary significantly over time, reflecting both tax law changes and overall business conditions, but in recent years they accounted for about 10 to 12 percent of total receipts, which is more than their share of receipts in the early-to-mid 1980s (9 percent). Other taxes and receipts (e.g., excise taxes, estate and gift taxes, customs duties) collectively have accounted for a smaller share of total receipts recently (7 percent) than in the first part of the 1980s (11 percent).

Over the span of the past 30 years, Federal receipts have averaged about 18.1 percent of GDP (see Table 5). In the first half of the 1980s, receipts averaged about 18.5 percent of GDP. Receipts grew in the late 1990s, but in recent years have fallen relative to the size of the economy. For the last five years (2005-2009), receipts have averaged about 17.3 percent of GDP, below their average in the early 1980s and also below the average of the entire thirty year period.

The tax rate structures of the U.S. corporate and individual income taxes have changed quite a bit since 1980. This is especially apparent in the top income tax brackets; in 1980, the top individual income tax rate was 70 percent, while it is 35 percent today (Table 6). But the reduction is not limited to the very top. Tax rates have declined across the income spectrum. For example, the marginal rate for the median income taxpayer has fallen from 24 percent in 1980 to 15 percent today, and that for taxpayers at twice the median income has fallen from 43 percent in 1980 to 27 percent today. The top corporate tax rate has declined as well, from 46 percent in 1980 to 35 percent today (Table 7). The reduction is even greater if the domestic production deduction, which operates in a manner similar to a tax rate cut for companies that can claim it, is taken into consideration.

For individuals across much of the income spectrum, however, the significance of the alternative minimum tax (AMT) in determining tax liability has changed dramatically over the past 30 years. Indeed, 30 years ago the AMT in its current form did not exist.

First enacted in 1969 largely as an add-on tax, the minimum tax was intended to ensure that high income individuals who otherwise would have paid no income tax would pay at least some tax. The minimum tax in its current form dates to 1982 and is an alternative (or parallel) tax system whose base is larger and tax rates (generally) lower than those for the regular income tax. Taxpayers are required to pay the larger of their liability under the AMT or under the regular income tax. An AMT exemption amount was provided in order to limit the AMT to well-off taxpayers.

Although the base of the AMT has not changed significantly since 1986, the AMT rate has been raised several times (Table 6). Moreover, the AMT exemption amount has not been indexed for inflation (one of the few major dollar-denominated provisions of the individual income tax that has not been indexed). Congress has increased the exemption several times since 1982, but in recent years these increases have been in the form of temporary "patches", short-term adjustments that roughly reflect inflation. In 2009, approximately 4 million taxpayers paid the AMT, and the AMT raised about $32 billion in tax revenue, reflecting its importance as a feature of the individual income tax.

Although the number of AMT taxpayers has increased since the mid-1980s, to date the *ad hoc* increases in the exemption amount have been successful in limiting the AMT to higher income taxpayers and to limiting the revenue raised from the AMT (see Figure 1). However, the AMT exemption for joint filers has reverted to $45,000 under current law from $70,950 for tax year 2009, and, without Congressional action in 2010, the number of taxpayers on the AMT will rise to about 28 million, and the revenue collected from the AMT will rise to about $100 billion. In the FY 2011 Budget, the President proposed to permanently index the important AMT parameters for inflation, to prevent this dramatic increase from occurring.

The character of tax expenditures has also changed over the past 30 years (see Figure 2). Tax expenditures are special features of the tax code intended to provide a benefit to particular industries, activities, investments, or taxpayers. Some tax expenditures are intended to promote purely economic goals. An example is accelerated depreciation, intended to increase investment, capital formation, and overall economic growth. Other tax expenditures are intended to promote social policy goals. An example is the Earned Income Tax Credit (EITC), which is a major part of the economic safety net for low income taxpayers. The EITC, claimed by 25 million taxpayers in 2008 has been called the most effective Federal anti-poverty program. Over the 1980-2010 period, total tax expenditures more than doubled in real, inflation adjusted terms. This suggests that the tax code has been increasingly used over the past three decades to pursue all kinds of non-tax policies, even allowing for the problems with adding up tax expenditure estimates and the interactions between them, as well as the ambiguities in the classification of some tax incentives as promoting primarily business or social policies.

The tax system also reflects changing demographics. Thirty years ago, about half of all tax returns were joint returns filed by married couples, and most of the rest were single returns. Today, joint returns account for less than 40 percent of all returns and the share of returns filed by heads of households, who are mostly single parents, has about doubled, to 15 percent.

By many measures, the U.S. tax system has become increasingly complex in recent decades. For example, the instruction book for the primary individual income tax form has grown from 52 pages for 1980 to 174 pages for 2009. The income tax regulations have doubled, from less than 7,500 pages in 1980 to nearly 15,000 pages today. Between 1980 and 2008, tax returns filled out using paid preparers have increased from 38 percent of returns to 58 percent of returns. When software users are added in, about 85 percent of individual income tax returns rely on some form of assistance, either software used by the taxpayer or a practitioner. Individual taxpayers spent an estimated 2.7 billion hours complying with the income tax laws in 2008. Counting time and money spent on software and paid preparation, the individual income tax burden totaled $91 billion dollars.

The ever changing tax code is another feature of the past 30 years. Between 1980 and 2009, there were about 30 major tax bills enacted. Some have reduced taxes (e.g., the Economic Recovery Tax Act of 1981(ERTA) and the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)). Other have increased taxes (e.g., the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Omnibus Budget Reconciliation Act of 1993). These frequent changes to the tax code have contributed to complexity. But, they also have made planning more difficult, since they have increased uncertainty about future tax rules. The increased use of phase-ins and phase-outs and sunsets of various tax provisions has added to the confusion, uncertainty, and taxpayer compliance burdens.

Although the tax code has undergone large and frequent changes in the past three decades, over the 30 year period taken altogether, the overall progressivity of the tax system has changed very little when comparing the endpoints. It seems to be true that the distribution of after-tax income has become much more concentrated at the top of the income scale. However, this mostly reflects changes in the pre-tax distribution of income rather than changes in the distributional consequences of the entire Federal tax system: the change in the distribution of after-tax income is very similar to the change in the distribution of pre-tax income.

For example, according to CBO data (see Table 2), between 1979 and 2007, the share of pre-tax income going to those in the lowest income quintile fell by 1.7 percentage points (from 5.7 percent to 4.0 percent), just about the same size as the 1.9 percentage point decline in the share of after-tax income that went to the lowest income quintile. All of the other income quintiles exhibited similar declines, except for the highest income quintile. The share of pre-tax income going to the highest quintile increased from 45.8 percent to 55.9 percent, while the after-tax share rose from 42.8 percent to 52.5 percent.

However, things appear to be somewhat different at the very top of the income distribution. According to several researchers, Federal tax policy changes, taken as a whole, have made the tax system less progressive at the very top of the income distribution, in contrast to the situation for the rest of the population. For example, Piketty and Saez (2007) compute average effective Federal tax rates (including all significant Federal taxes), for the top $1/100^{th}$ of 1 percent of the income distribution and show that they fall sharply, from 59.3 percent in 1980 to 34.7 percent in 2004, where as the average tax rate for the full population falls much more modestly, from 26.6 percent to 23.4 percent.[1] This reduction in tax progressivity, however, is not observed as one moves down the income scale in Piketty and Saez's calculations. In summary, over the 1980-2004 period, tax changes seem to have had roughly offsetting effects on progressivity, leaving the tax code at the end of the period about as progressive as it was at the beginning, at least for the vast majority of the income distribution. Other researchers extend these findings out a few more years and do not find that significant modifications to that conclusion are warranted.

Comparison to Other Countries' Tax Systems

The U.S. tax system has also changed in relation to the tax systems in the rest of the world. This is especially true with respect to corporate taxes (see Figure 3). Thirty years ago, the United States had a statutory corporate tax rate that was about the same as the rate in other developed countries (less than the mean, greater than the median for other OECD countries). In 1986, the U.S. corporate income tax rate was reduced by twelve percentage points, which made the United States a relatively low corporate income tax rate country for the next several years. Since that time, however, other developed countries have cut their maximum corporate tax rates, and the United States now has a statutory corporate rate that is above that in most other developed countries. When viewed in terms of revenue raised as a percentage of GDP, the U.S. corporate

[1] Thomas Piketty and Emmanuel Saez, *"How Progressive is the U.S. Federal Income Tax System? A Historical and International Perspective"*, Journal of Economic Perspectives, Winter 2007, pp 3-24.

income tax is about equal to the OECD average. When viewed in the context of the after-tax cost of a marginal investment, the U.S. corporate income tax is again comparable to other OECD countries, and on the low side for debt-financed investment.

The U.S. system for taxing the foreign source income of U.S. multinational corporations also has diverged from the tax systems used in other major developed countries. The United States continues to use a so called "world-wide" system, in which the United States subjects to income tax income earned abroad by the foreign subsidiaries of U.S. multinationals (generally, this income is taxed when it is repatriated to the U.S.-based parent, in the form of a dividend or other payment). This reduces a U.S.-based multinational corporation's incentive to invest abroad in low-tax jurisdications, rather than in the U.S. In contrast, other major developed countries use a "territorial tax system," which exempts all or a portion of active foreign earnings from home country tax.

Another important difference between the U.S. tax system and the tax systems in other developed countries is the reliance on consumption taxes, such as value added tax (VAT). The VAT is a consumption tax, collected incrementally at each stage of the production and distribution process. In 1980, 14 OECD countries had a VAT (not including the U.S.). In 2009, 29 of the 30 OECD countries had a VAT, with the U.S. being the outlier. Moreover, VATs represent large shares of the revenue base in most developed countries. For example, the average OECD VAT raises revenue equivalent to about 11 percent of GDP and, for the OECD as a whole, VATs raise about 19 percent of all revenue. In contrast, consumption (excise) taxes at the Federal level in the U.S. make up about 3 percent of revenues.

Implications for Tax Policy

The current position of the U.S. economy and tax system, as well as the changes over the past three decades, suggest a number of factors that are relevant in formulating tax policy for the future.

First, we face the future from a position of economic strength *vis-a-vis* the rest of the world. Nonetheless, if we are to continue to compete successfully with high growth rate emerging and developing countries, the U.S. needs a tax code that appropriately encourages economic growth.

Second, given Federal budget considerations, as recognized in successive Administration budgets, there is likely to be a need for the tax system to raise additional revenue in coming years. This could take the form of broadening the tax bases for income taxes, increasing some tax rates, or through other measures.

Third, while designing a tax system to promote economic growth is important, so is fairness (generally characterized as progressivity). Any changes to the tax code need to be cognizant of the implications they have for the overall distribution of income and tax burdens.

Fourth, business tax policy in the United States should consider the effects on non-corporate businesses such as S corporations and partnerships. In addition, tax policy should consider potential effects on the ability of U.S. based firms to thrive in the global economy.

Fifth, future tax policy changes should confront the AMT. Permanently indexing important parameters of the AMT, as proposed in successive Administration budgets, is one way to simplify and rationalize the individual income tax system.

Sixth, and finally, significant attention should be paid to simplification of the tax code, with an aim of reducing both the burden that taxpayers face in terms of time and out-of-pocket expenses to comply with the income tax laws and the resources required for the IRS to administer the tax system.

Thank you. I would be happy to answer any questions you may have.

Table 1: US vs. World GDP (2005 $ billions)

	1980	1985	1990	1995	2000	2005	2010
World	$22,258	$25,294	$29,999	$33,208	$39,297	$45,004	$49,933
Developed	$17,131	$19,381	$22,927	$25,178	$29,446	$32,402	$33,568
US	$5,839	$6,849	$8,034	$9,094	$11,226	$12,638	$13,190
Developing	$3,679	$4,231	$5,251	$6,707	$8,364	$10,667	$14,086
Former Centrally Planned	$1,448	$1,683	$1,822	$1,324	$1,486	$1,935	$2,279
Emerging Markets	$2,916	$3,512	$4,330	$5,126	$6,441	$8,405	$11,207
Developing and Formerly Centrally Planned	$5,127	$5,913	$7,072	$8,030	$9,850	$12,602	$16,366
US Share	26.2%	27.1%	26.8%	27.4%	28.6%	28.1%	26.4%
Developing country share	16.5%	16.7%	17.5%	20.2%	21.3%	23.7%	28.2%

Source: Economic Research Service of the US Department of Agriculture, based on data from the International Monetary Fund and other sources.

Table 2: Pre-tax and After-tax Income Shares

Year	Lowest Quintile			Second Quintile			Middle Quintile			Fourth Quintile			Highest Quintile			Top 1 Percent		
	Pre-Tax	After-Tax	Ratio After-tax to Pre-Tax Shares	Pre-Tax	After-Tax	Ratio After-tax to Pre-Tax Shares	Pre-Tax	After-Tax	Ratio After-tax to Pre-Tax Shares	Pre-Tax	After-Tax	Ratio After-tax to Pre-Tax Shares	Pre-Tax	After-Tax	Ratio After-tax to Pre-Tax Shares	Pre-Tax	After-Tax	Ratio After-tax to Pre-Tax Shares
1980	5.7	6.8	1.19	11.0	12.1	1.10	15.7	16.5	1.05	22.1	22.3	1.01	45.8	42.8	0.93	9.1	7.7	0.85
1985	4.8	5.5	1.15	10.1	10.9	1.08	15.2	15.8	1.04	21.9	22.0	1.00	48.6	46.7	0.96	11.5	10.6	0.92
1990	4.6	5.3	1.15	10.0	10.8	1.08	15.1	15.8	1.05	21.6	21.9	1.01	49.5	47.3	0.96	12.1	11.0	0.91
1995	4.6	5.5	1.20	9.7	10.9	1.12	14.9	15.9	1.07	21.3	21.9	1.03	50.2	46.8	0.93	12.5	10.3	0.82
2000	4.0	4.9	1.23	8.6	9.7	1.13	13.5	14.7	1.09	19.6	20.2	1.03	54.8	51.3	0.94	17.8	15.5	0.87
2005	4.0	4.8	1.20	8.5	9.6	1.13	13.4	14.5	1.08	19.7	20.5	1.04	55.1	51.5	0.93	18.1	15.6	0.86
2006	3.9	4.7	1.21	8.3	9.4	1.13	13.2	14.3	1.08	19.5	20.3	1.04	55.7	52.2	0.94	18.8	16.3	0.87
2007	4.0	4.9	1.23	8.4	9.4	1.12	13.1	14.1	1.08	19.3	20.0	1.04	55.9	52.5	0.94	19.4	17.1	0.88

Source: Congressional Budget Office.

Table 3: Shares of Total Business Returns, Receipts and Net Income, 1980-2007

	1980	1985	1990	1995	2000	2005	2006	2007
C Corporations 1/								
Returns	0.166	0.151	0.107	0.103	0.087	0.066	0.063	0.058
Total Receipts	0.870	0.855	0.771	0.748	0.708	0.664	0.656	0.654
Business Receipts	0.862	0.847	0.747	0.726	0.680	0.633	0.625	0.621
Net Income (less Deficit)	0.783	0.714	0.572	0.578	0.432	0.540	0.484	0.437
All Flow-Throughs 2/								
Returns	0.834	0.849	0.893	0.897	0.913	0.934	0.937	0.942
Total Receipts	0.130	0.145	0.229	0.252	0.292	0.336	0.344	0.346
Business Receipts	0.138	0.153	0.253	0.274	0.320	0.367	0.375	0.379
Net Income (less Deficit)	0.217	0.286	0.428	0.422	0.568	0.460	0.516	0.563

Source: IRS Statistics of Income, relevant years

Notes:

1/ Excludes RICs & REITS

2/ Includes LLCs & LLPs

Table 4: Percentage Composition of Receipts by Source, 1980 -2010

Fiscal Year	Individual Income Taxes	Corporation Income Taxes	Social Insurance Total	Excise Taxes	Other
1980	47.2	12.5	30.5	4.7	5.1
1981	47.7	10.2	30.5	6.8	4.8
1982	48.2	8.0	32.6	5.9	5.3
1983	48.1	6.2	34.8	5.9	5.0
1984	44.8	8.5	35.9	5.6	5.2
1985	45.6	8.4	36.1	4.9	5.0
1990	45.2	9.1	36.8	3.4	5.4
1995	43.7	11.6	35.8	4.3	4.6
2000	49.6	10.2	32.2	3.4	4.5
2005	43.1	12.9	36.9	3.4	3.8
2006	43.4	14.7	34.8	3.1	4.0
2007	45.3	14.4	33.9	2.5	3.9
2008	45.4	12.1	35.7	2.7	4.2
2009	43.5	6.6	42.3	3.0	4.7
2010 estimate	43.2	7.2	40.4	3.4	5.7

Source: Historical Tables, Budget of the U.S. Government, Fiscal Year 2011

Table 5: Receipts by Source as a Percentage of GDP, 1980 - 2010

Fiscal Year	Individual Income Taxes	Corporation Income Taxes	Social Insurance	Excise Taxes	Other	Total Receipts
			Total			Total
1980	9.0	2.4	5.8	0.9	1.0	19.0
1981	9.4	2.0	6.0	1.3	0.9	19.6
1982	9.2	1.5	6.3	1.1	1.0	19.2
1983	8.4	1.1	6.1	1.0	0.9	17.5
1984	7.8	1.5	6.2	1.0	0.9	17.3
1985	8.1	1.5	6.4	0.9	0.9	17.7
1990	8.1	1.6	6.6	0.6	1.0	18.0
1995	8.0	2.1	6.6	0.8	0.9	18.4
2000	10.2	2.1	6.6	0.7	0.9	20.6
2005	7.5	2.2	6.4	0.6	0.7	17.3
2006	7.9	2.7	6.3	0.6	0.7	18.2
2007	8.4	2.7	6.3	0.5	0.7	18.5
2008	7.9	2.1	6.2	0.5	0.7	17.5
2009	6.4	1.0	6.3	0.4	0.7	14.8
2010 estimate	6.4	1.1	6.0	0.5	0.8	14.8

Source: Historical Tables, Budget of the U.S. Government, Fiscal Year 2011

Table 6: Federal Individual Income Tax Parameters

	Regular Income Tax									Alternative Minimum Tax		
Year	Standard Deduction-Single	Standard Deduction-Joint	Personal Exemption	Lowest Statutory Tax Rate (Percent)	Highest Statutory Tax Rate (Percent)	Marginal Tax Rate at Median Income	Marginal Tax Rate at 2x Median Income	Maximum Tax Rate on Capital Gains (Percent)	Maximum Tax Rate on Dividends (Percent)	Exemption-Single	Exemption-Joint	Maximum Tax Rate (Percent)
1980	$2,300	$3,400	$1,000	14.0	70.0	24.0	43.0	28.0	70.0	n/a	n/a	n/a
1985	$2,390	$3,540	$1,040	11.0	50.0	22.0	38.0	20.0	50.0	$30,000	$40,000	20.0
1990	$3,250	$5,450	$2,050	15.0	28.0	15.0	28.0	28.0	28.0	$30,000	$40,000	24.0
1995	$3,900	$6,550	$2,500	15.0	39.6	15.0	28.0	28.0	39.6	$33,750	$45,000	28.0
2000	$4,400	$7,350	$2,800	15.0	39.6	15.0	33.3	20.0	39.6	$33,750	$45,000	28.0
2005	$5,000	$10,000	$3,200	10.0	35.0	15.0	30.1	15.0	15.0	$40,250	$58,000	28.0
2006	$5,150	$10,300	$3,300	10.0	35.0	15.0	30.1	15.0	15.0	$42,500	$62,550	28.0
2007	$5,350	$10,700	$3,400	10.0	35.0	15.0	25.0	15.0	15.0	$44,350	$66,250	28.0
2008	$5,450	$10,900	$3,500	10.0	35.0	15.0	30.0	15.0	15.0	$46,200	$69,950	28.0
2009	$5,700	$11,400	$3,650	10.0	35.0	15.0	27.0	15.0	15.0	$46,700	$70,950	28.0
2010	$5,700	$11,400	$3,650	10.0	35.0	15.0	27.0	15.0	15.0	$33,750	$45,000	28.0

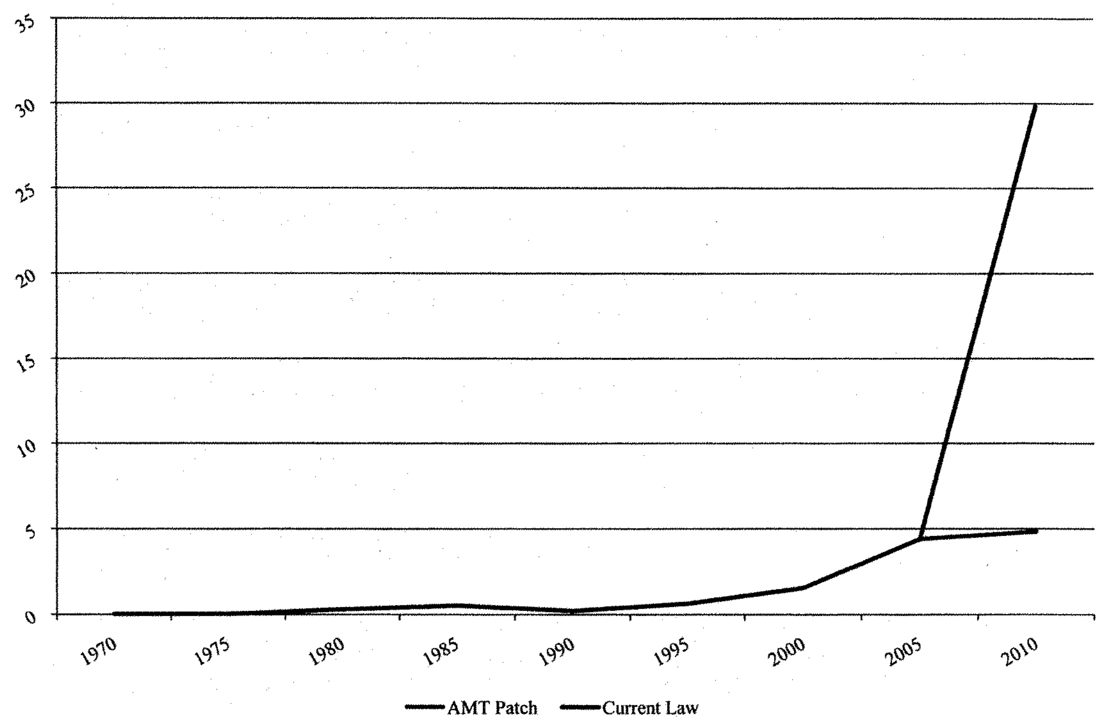
Source: Office of Tax Analysis, U.S. Department of the Treasury

Table 7: Corporate Tax Rate: 1980-2010

Year	Top Corporate Rate	Top Rate, Domestic Production Activities
1980	46.00	n/a
1985	46.00	n/a
1990	34.00	n/a
1995	35.00	n/a
2000	35.00	n/a
2005	35.00	33.95
2006	35.00	33.95
2007	35.00	32.90
2008	35.00	32.90
2009	35.00	32.90
2010	35.00	31.85

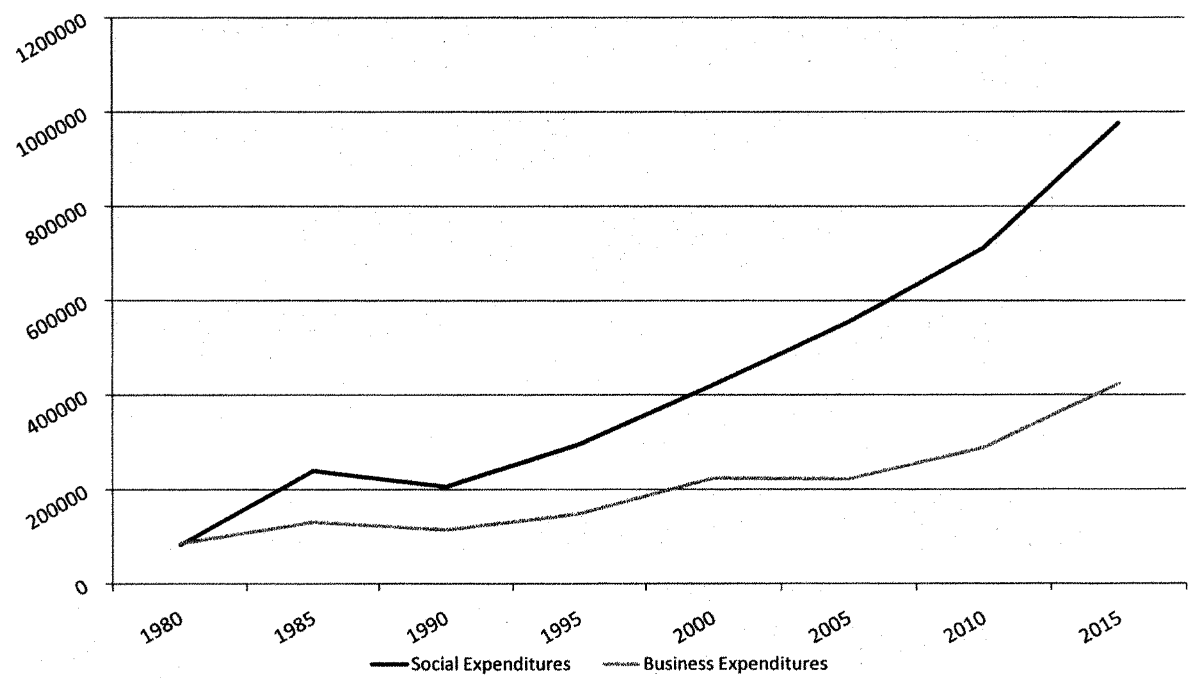
Source: Office of Tax Analysis,
U.S. Department of the Treasury

Figure 1: AMT Taxpayers as a Percentage of All Taxpayers, 1970-2010



Source: Office of Tax Analysis, U.S. Department of the Treasury

Figure 2: Social and Business Tax Expenditures, Estimates for 1980-2015



Tax expenditures estimates in current dollars (millions). Estimates for 2010-2015 are based on the Administration's budget forecasts.
Source: Office of Tax Analysis, U.S. Department of the Treasury

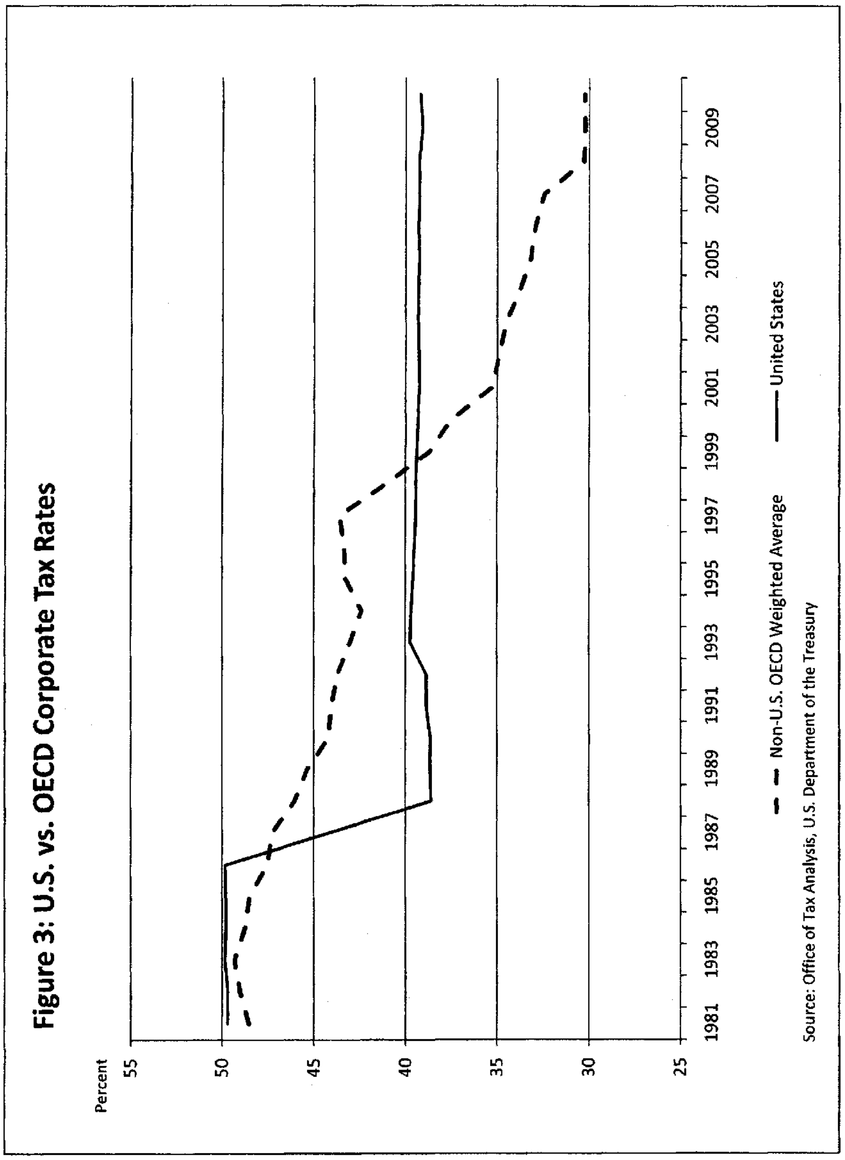


Figure 3: U.S. vs. OECD Corporate Tax Rates
Percent
55
50
45
40
35
30
25
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
Non-U.S. OECD Weighted Average
United States
Source: Office of Tax Analysis, U.S. Department of the Treasury