Dēmos

Trends in Revenue and the Fiscal Condition

About Dēmos

Dēmos is a non-partisan public policy research and advocacy organization. Headquartered in New York City, Dēmos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world. Dēmos was founded in 2000.

In 2010, Dēmos entered into a publishing partnership with *The American Prospect*, one of the nation's premier magazines focussing policy analysis, investigative journalism, and forward-looking solutions for the nation's greatest challenges.

About the **Our Fiscal Security Project**

The Our Fiscal Security project is a collaborative effort of the Economic Policy Institute, Demos, and The Century Foundation. Our institutions are dedicated to promoting an economic path that achieves fiscal responsibility without undermining our national strength. Today, the foundation of that strength – a secure and growing middle class – is being tested by falling incomes, lost wealth, high unemployment and record foreclosures. Yet instead of rebuilding the public structures that could fortify our economy, our elected leaders are facing misguided pressure to reduce the federal budget deficit.

We believe the first priority for our nation is to secure the fundamentals of the economy: strong growth and good jobs. We also believe that in order to reduce our long-term national debt we must refuel the engine of our economy: the middle class. Finally, we strongly oppose the idea that America's fiscal challenges can be solved by cutting longstanding social insurance programs that have brought security and prosperity to millions of Americans. Putting our nation on a path of broad prosperity will require generating new jobs, investing in key areas, modernizing and restoring our revenue base and lowering the costs of our health care system. Achieving these goals, however, will require an informed and engaged public to help set our national priorities.

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Introduction

The fiscal condition of the federal government has been the subject of much debate recently. The recession has led to an increase in deficits in the short run as revenues have declined due to rising unemployment.The federal deficit in 2010 is expected to total $1.3 trillion, or about 9 percent of GDP.[1] While this increase in short-run deficits is natural and even beneficial to the economy, the long-term outlook for the federal government's finances is worrisome.. Many pundits argue that government spending is out of control, and massive cuts in spending, focusing heavily on Social Security and Medicare, are the only solution to close these large deficits. Left out of this analysis, however, is the role that tax policy has played in reducing the amount of revenue available to fund national needs. As a result of changes to the tax code in the last decade and the impact of the recession, tax revenue in the United States are at historic lows, and far lower than other developed nations.

In contrast, government spending over the last two decadeshas risen quite modestly. In the 1990s, government spending as a share of the economy fell from 21.9% in 1990 to 18.5% in 1999.[3] In the aughts, spending prior to the recessionwent from from 18.2% of the economy in 2000 to 19.6% in 2007,[4] a rise largely attributable to the expenses of the two unfunded wars in Iraq and Afghanistan. The current deficit is largely a product of the steep drop in revenue caused by the large tax cuts at the beginning of the decade, increased security spending, emergency spending to rescue the economy and financial sector, and temporary declines in revenues due to high unemployment. Attributing the rising deficit and national debt to runaway government spending not only misdiagnoses the cause of our fiscal challenges, it prescribes the wrong remedies. A necessary component for deficit reduction is economic growth—which means our long-term fiscal outlook hinges on our ability to create jobs and rebuild the middle class.

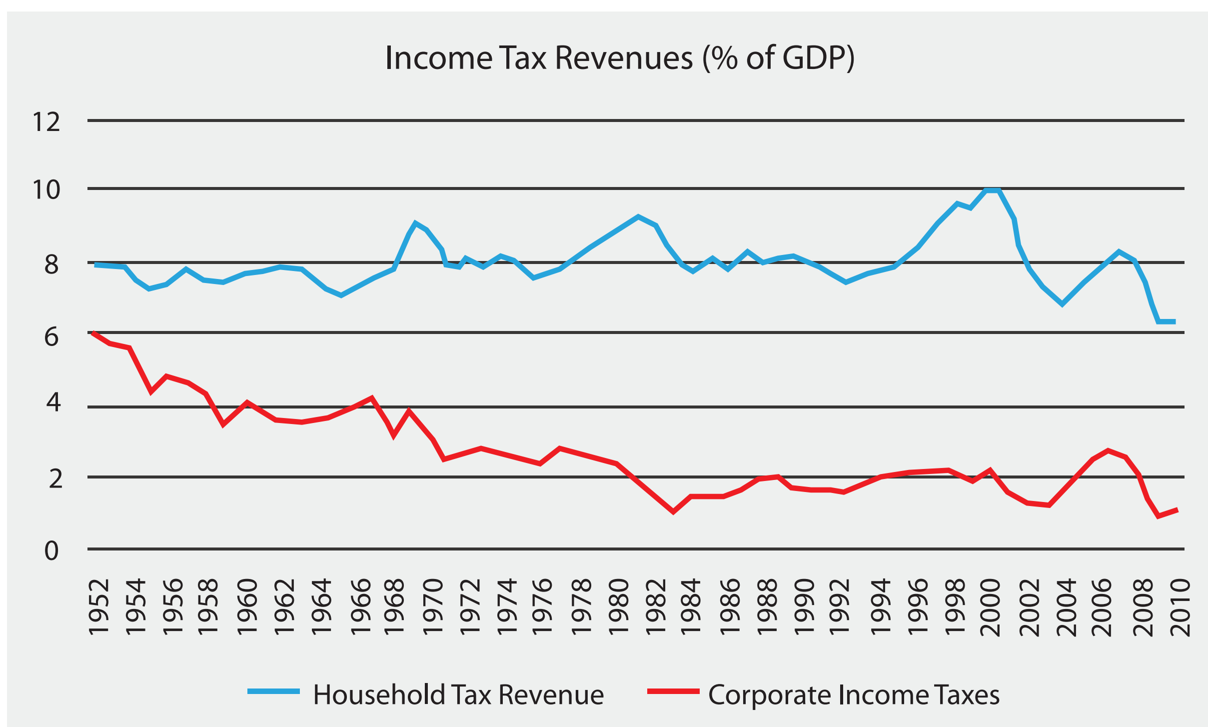
A prescription of massive domestic spending cuts is the worst policy for an economy already staggering under the weight of nearly 10 percent unemployment and years of underinvestment in critical infrastructure. Cutting national investments would in fact weaken the economy and compound our national fiscal challenges in the long term.

In order to build a platform for sustained economic growth, our nation must do two things: first, we must ensure a full recovery from the recession, which means getting people back to work, and second, we must plan for longer-term investments which will lay the foundation for sustained growth and a stronger middle class. In order to accomplish these goals, our nation will need to replenish its revenue base, which has fallen as a result of changes in tax policy over the last decade, and has been exacerbated by the recession. This fact sheet examines trends in our nation's major sources of revenue: federal income taxes and corporate income taxes. It also examines in more detail tax expenditures—special tax breaks and benefits in the tax code which lower the overall revenue collected by the government.

A Brief History of Federal Revenue and Taxation

Historical and International Comparison

Federal tax revenue is lower than it has been in half a century. The federal government's revenues from income taxes on households make up 6.4 percent of GDP; which is 1.1 percentage points lower than half a century ago in 1959, and 3.8 percentage points lower than the peak in the boom year of 2000.[5] Corporate income taxes, at 1 percent of GDP, are 2.5 percentage points lower than fifty years ago and 6.2 percentage points lower than their apex in 1945. Our current tax revenues are not only low relative to historical levels, but they rank low internationally as well. Our total tax revenues, including federal, state, and local taxes, comprise 27 percent of GDP, a level far lower than most of our peers in the developed world.[6] The highest of the group, Denmark, takes in almost twice as much as we do, relative to its GDP, and even supposedly "low tax" countries such as Ireland (28%) and Switzerland (29%) collect more revenue, as a fraction of GDP, than does the United States. In fact, among the 33 nations of the Organisation for Economic Co-operation and Development (OECD), only three (Korea, Turkey and Mexico) take in proportionately less tax revenue than we do.

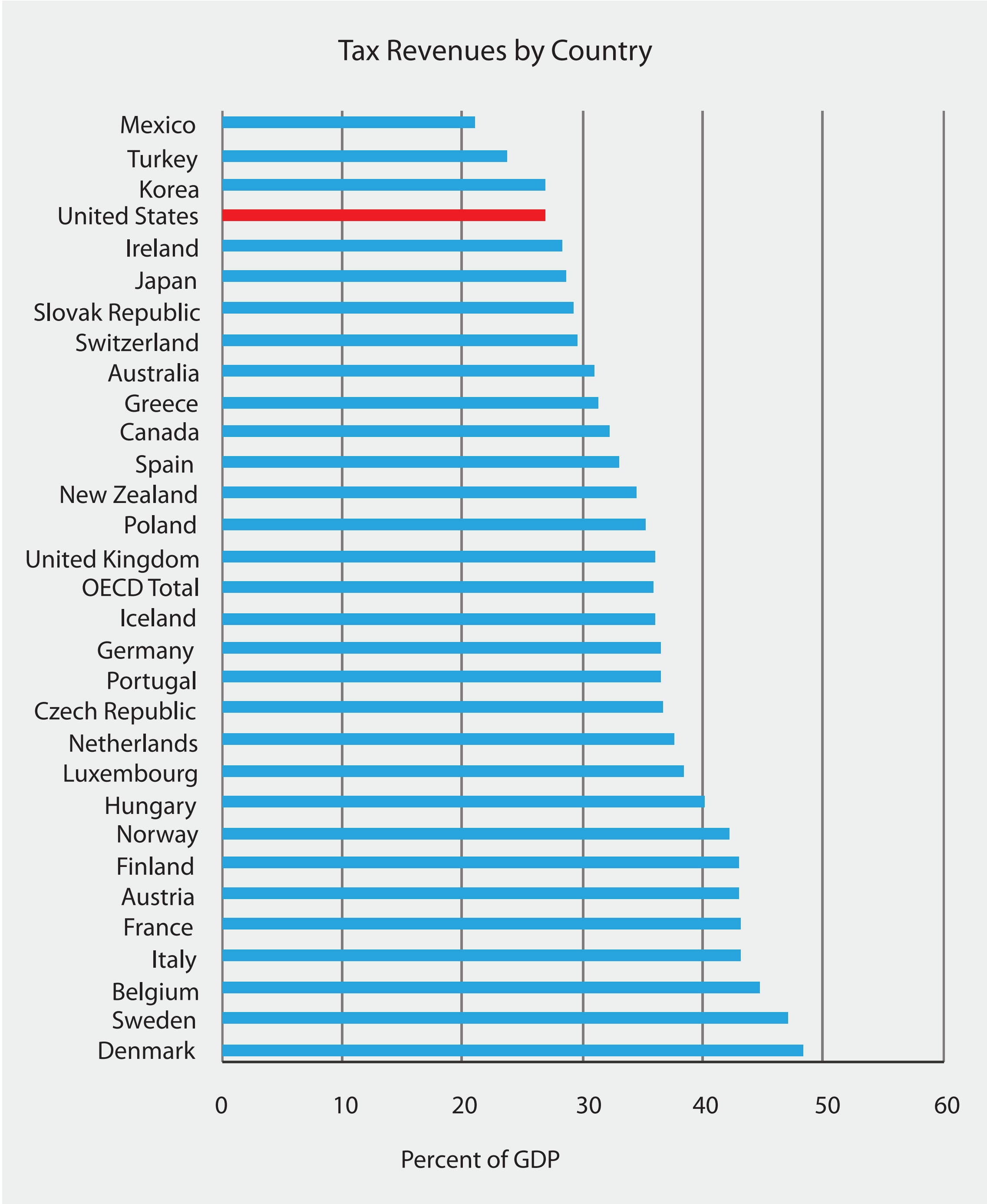


Source: Office of Management and Budget, Historical Tables, Budget of the United States Government, 2009, Table 1.1

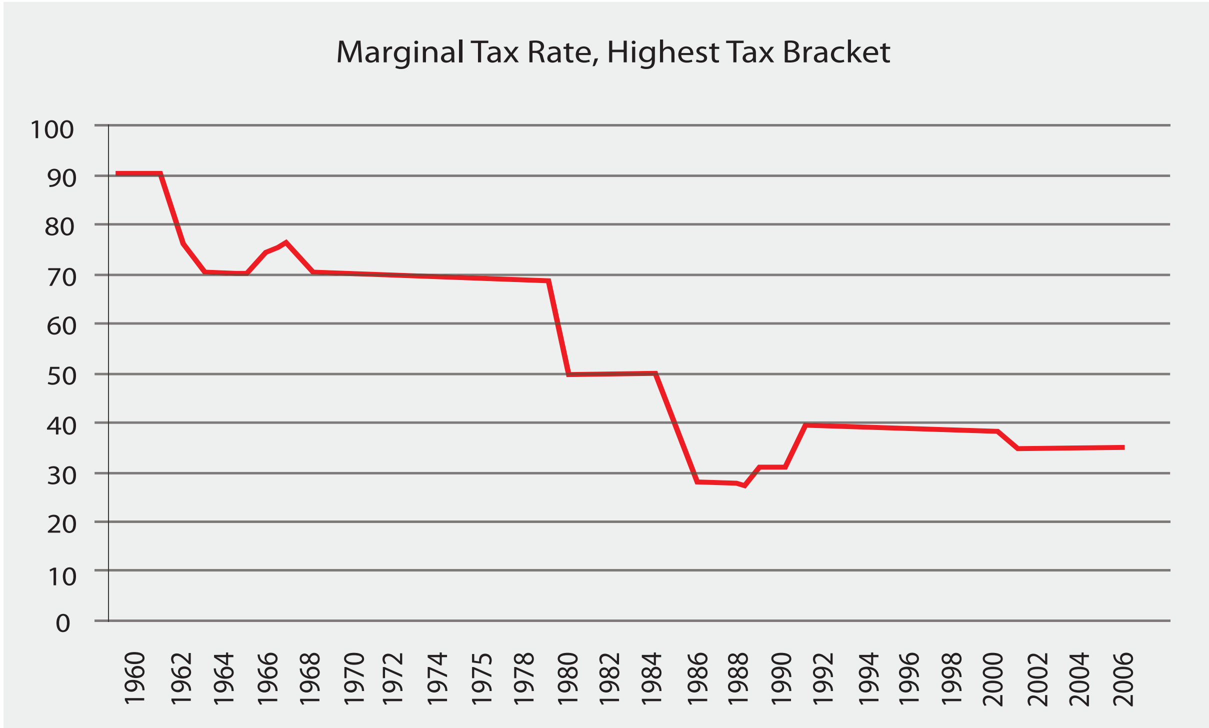
Income Tax Rates over Time

Though tax rates have decreased from 1981 to the present for households across the income spectrum, the steep fall in federal tax revenue was caused largely by cuts in the tax rates for the very wealthiest households. The current marginal tax rate for the highest income bracket—in other words, the tax rate on income above a threshold for the wealthiest taxpayers— of 35 percent is among the lowest since WWII, far lower than the 80 percent rate during the high-growth 60s and the 39.6 percent rate of much of the 1990s.[7] The effective tax rate, the actual percentage of a household's entire income paid in taxes, for the rich has also fallen precipitously, dropping from 31.3 percent for millionaires in 1993 to 22 percent today.[8] The wealthiest 400 households, who currently pay only about 17 percent of their income in taxes[9], have seen an even larger decrease. These households earn most of their income through earnings on investments—

including capital gains and dividends; the tax rates on which have decreased faster than those on income, as explained below. Though many households in the country currently pay lower taxes than in the past, most of the fall in government revenues is due to the tax cuts for the upper quintiles; tax cuts for these earners have a large effect on government revenues, as a large proportion of those revenues come from taxes on the largest incomes.



Source: OECD Tax Database Table O.1



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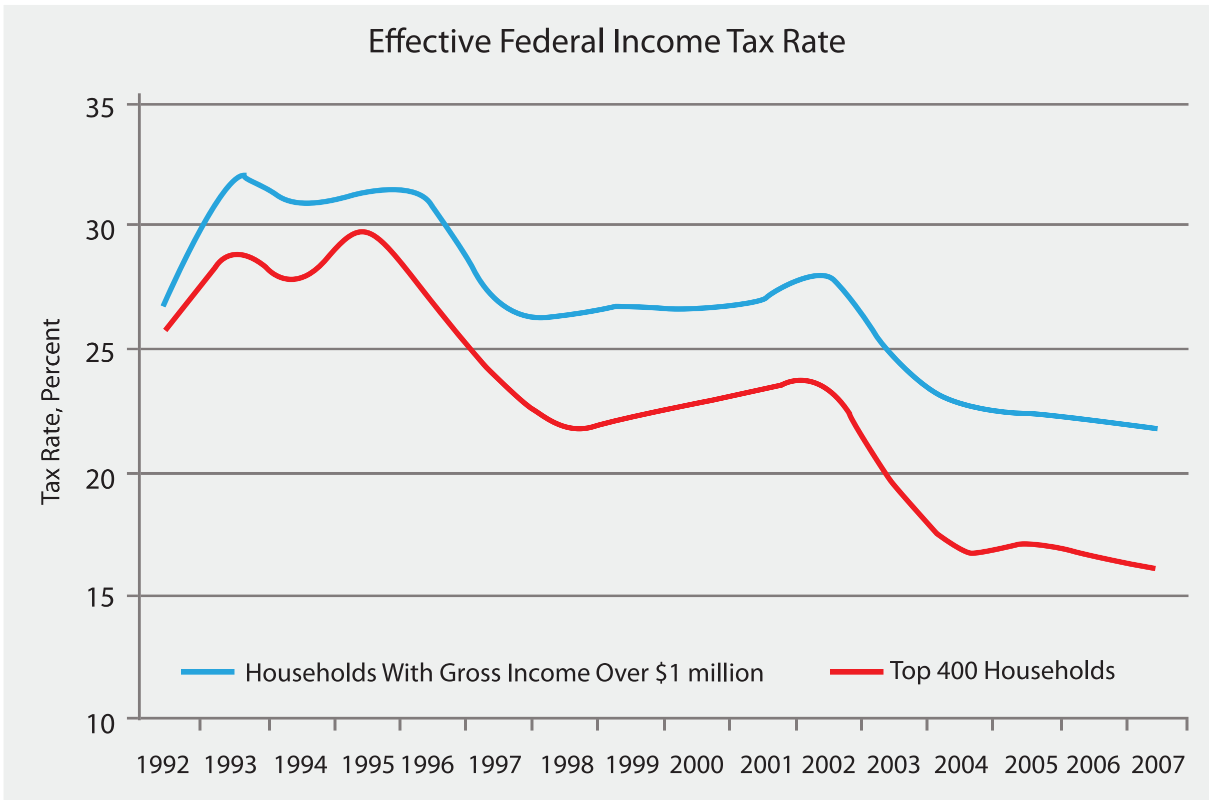
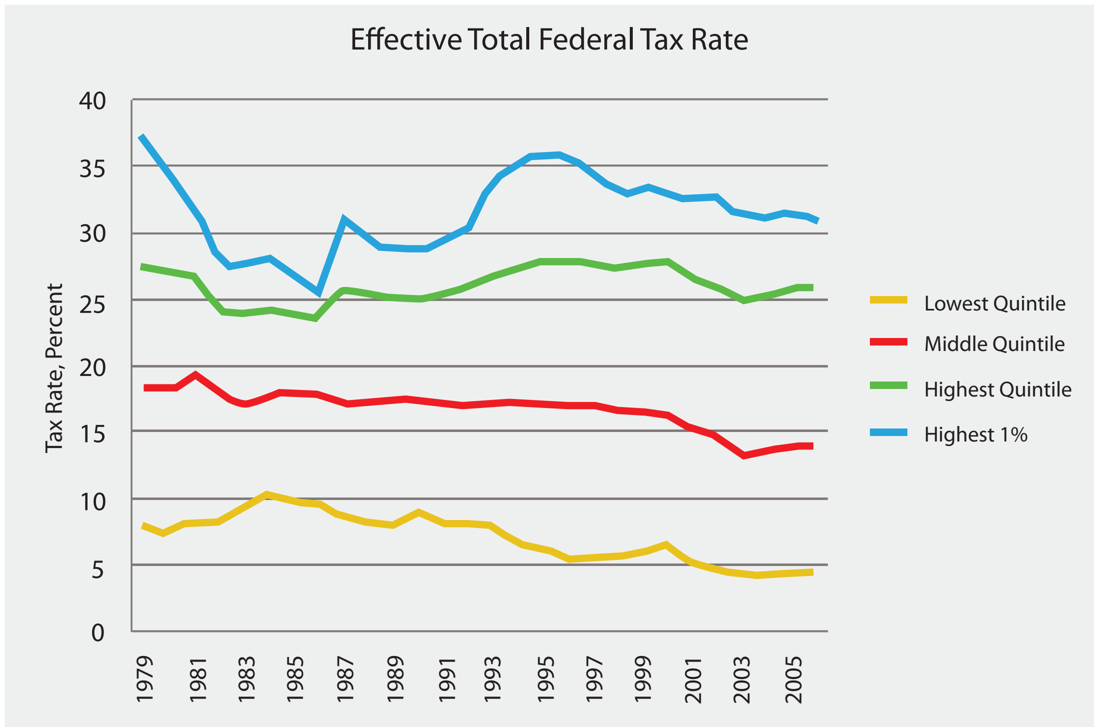


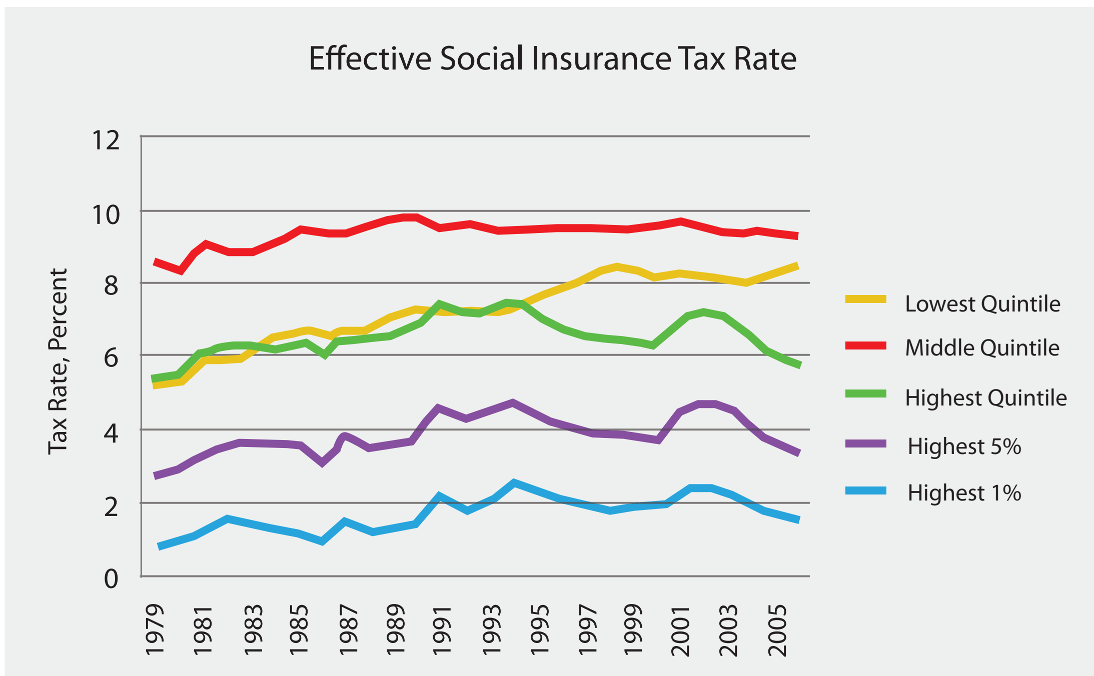
Source: Center on Budget and Policy Priorities (CBPP). [10]



Source: Tax Policy Center[11]

Wealth Taxed Less Than Work

The falling income tax rate on the highest bracket is not the primary reason the very wealthiest Americans pay significantly lower taxes than they used to. In reality, cuts to the capital gains tax rate were primarily responsible for the steadily falling tax share of the rich. Capital gains, or profits earned from the sale of investments in capital such as stocks, bonds, or real estate, are the means by which many



Source: Tax Policy Center[14]

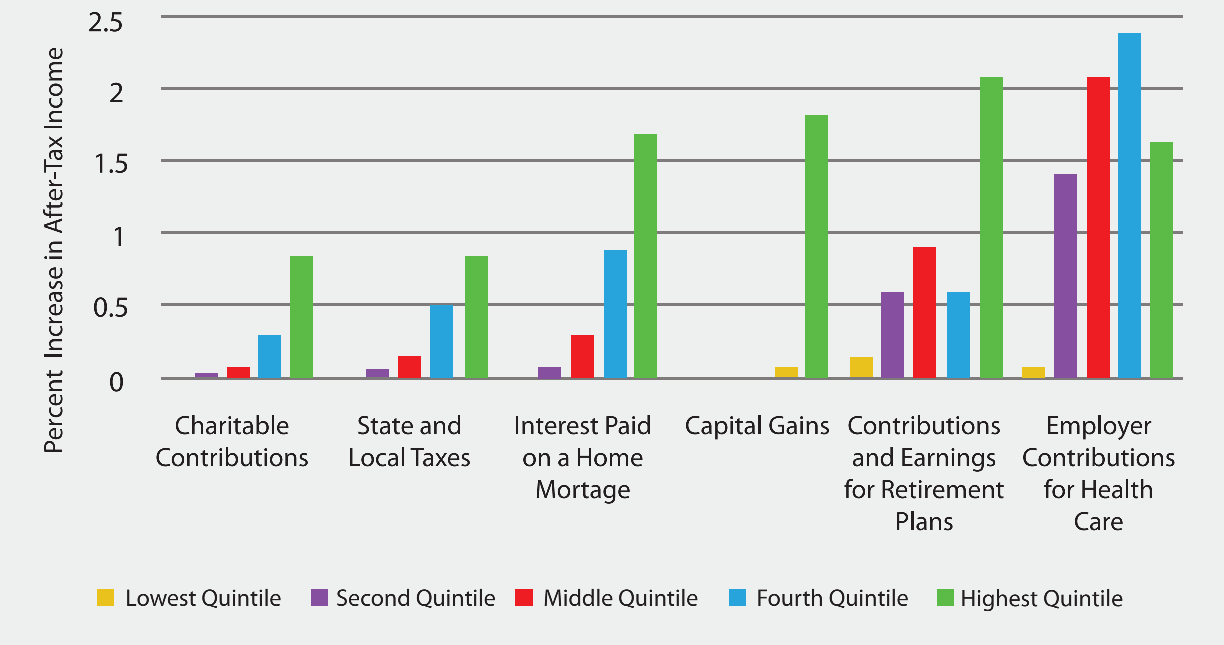
of the wealthiest households in the country earn the majority of their income, and the tax rate on that income has fallen even faster than those on ordinary wage income described above. Tax rates on corporate dividends have fallen as well. Capital gains were responsible for 66 percent of the income of the wealthiest 400 households in the country in 2007 and 21percent of the income of households with incomes between $500,000 and $1 million.[12] The tax rate on capital gains has steadily decreased from its post-war high of nearly 40 percent in 1978 to 20 percent through much of the 80s to a low of 15 percent today.

Social Insurance Taxes Fall Heaviest on the Poor

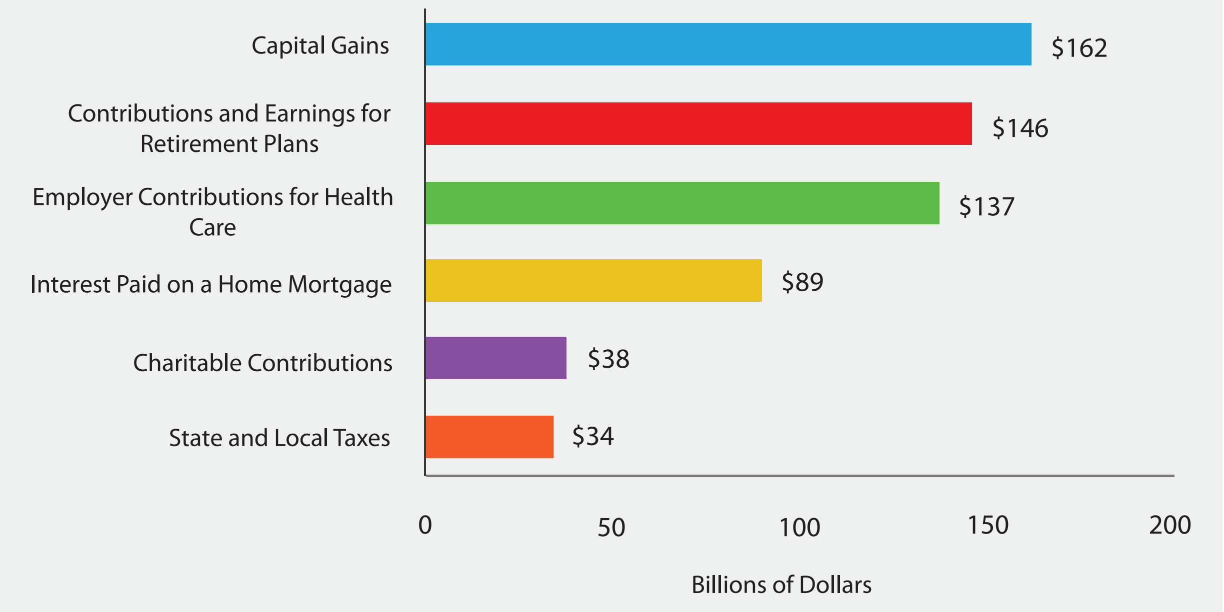
The social insurance tax rate—the combined tax rate for Social Security and Medicare—has not fallen for the wealthiest. All households who earn wage income pay 6.2 percent of that income for Social Security and 1.45 percent for Medicare. Employers pay an equal amount on behalf of their employees. The Social Security tax, however, is only levied on the first $106,800 of an individual's yearly income, an amount that increases slightly each year. Any income above that threshold is still subject to other taxes—standard income taxes, the Medicare tax, etc.—but not Social Security. So, as the incomes of the highest earners rise further above the Social Security cap, their total effective social insurance tax—the total tax as a share of their total income—will decrease. The highest 20 percent of earners paid 5.7 percent of their income in social insurance taxes in 2007, nearly identical to the 5.4 percent they paid in 1979.[15] The social insurance tax rate on the highest quintile rose through the 90s as higher rates from social insurance tax increases authorized by Reagan were phased in. This quintile's rate fell again in the past few years as their incomes grew and a falling proportion was subject to the Social Security tax. Effective payroll taxes on the poor, however, have risen over the past 28 years[16] , eating up an additional 3.5 percent of the income of the poorest 20 percent of Americans, and another 1.8 percent of the income of the next 20 percent as the Reagan Administration's tax increases took effect.

Tax Expenditures are Costly and Inefficient

Falling marginal and capital gains tax rates are not the only causes of the decline in effective tax rates. The federal government also lost $878 billion in revenue in 2008[17] from individual income tax deductions and credits given out for a variety of activities including mortgage-interest deductions for owner-occupied homes and tax-free employer contributions for health insurance.[18] The benefits from these tax breaks, collectively referred to as tax expenditures, disproportionately flow to upper income households. Tax deductions for mortgage interest and retirement plan contributions are two of the most unequal, with roughly two-thirds of the tax savings from these benefits accruing to the highest earning 20 percent of households.



Source: Tax Policy Center



Source: Joint Committee on Taxation [19]
Particularly low due to the recession for 2010; projected to be $57 billion in 2011.

Revenue Fixes

To repair both our government's ailing finances and our sputtering economy, we not only need to raise revenue to improve the long-run fiscal outlook but also to fund investments in vital areas of the economy that have been neglected as revenues fell. By making investments in education and job training, green energy alternatives, and critical infrastructure such as the internet grid, bridges, etc., we not only stimulate the economy in the short run by creating new jobs, but we ensure its long term health by building the foundation needed for a prosperous 21st century economy. Investing in the future is the only way to ensure the long-term stability of the economy.

A few examples of ways by which we might raise this much-needed revenue are summarized in the table below. The table is by no means intended to be exhaustive; these are only a few of the many equitable, growth-positive ways to raise revenue. The list is simply meant to suggest a few ways through which the government could close the deficit and fund needed additional investments without forcing lower income Americans, already squeezed by stagnant wages and rising costs of living, to shoulder the burden. By enacting these or other similarly revenue proposals, the United States can both reduce the deficit and ensure prosperity for generations to come.

Revenue Source	How Does it Work?	How Much Will It Generate?
Financial Transactions Tax	A small tax on all financial transactions. The amount of the tax would vary by type of transaction, but would be no more than 0.50 percent per transaction. The tax would apply to trades of stocks, bonds, derivatives, currency, and other financial instruments.	Up to **$177 billion** per year[20]
18Surcharge on Top Earners	Charge a 5.4% surcharge on income for joint filers with AGI above $1,000,000 (assumes the Bush tax cuts expire, so the top marginal rate becomes 45%).	**$31 billion** a year immediately, **$53 billion** a year by 2015[21].
Progressive Estate Tax	Implement graduated tax rates for estates valued at over $3.5 million for an individual. Estates would be taxed at a 45% marginal up to $10 million, 50% up to $50 million, 55% on up to $500 million, and 65% on estates worth over $500 million.	**$15 billion** per year immediately, **$319 billion** over the next decade [22]
Eliminate Capital Gains and Dividends Tax Preference	Tax capital gains and qualified dividends at the same rate as wage income (as was done after the 1986 Tax Reforms)	**$78 billion** in 2011, falling slightly to **$71 billion** a year by 2015[23].
Impose a Financial Crisis Responsibility Fee	Asses a fee on financial institutions with over $50 billion in assets (roughly 60 institutions) equal to fifteen basis points (0.15%) of a financial institution's covered liabilities	**$9 billion** per year
Reform International Tax System	Eliminate deferred taxation on foreign source income, reform the foreign tax credit, limit income shifting, and other reforms proposed in the president's budget request.	Approximately **$45 billion** a year.
Reforming Tax Expenditures	Eliminating or revising the most inefficient and inequitable tax expenditures, including tax deductions for mortgage interest and contributions to retirement and education savings accounts.	Replace the mortgage interest deduction with a tax credit: **$50 billion**[24] a year by 2014. Eliminate exclusion for employee contributions to retirement savings accounts: **$110 billion** in 2009, **$170 billion** by 2015[25]

Questions and Answers

Won't raising taxes slow the country's economic growth?

No—in fact, raising taxes may spur growth. This myth of higher taxes leading to reduced growth is derived from several false assumptions and exaggerated empirical claims, including:

- Government spending is always less effective as a stimulus than tax cuts.
- Government borrowing to finance increased spending will always crowd out private borrowing.
- Higher tax rates is a significant deterrent to work.

However, there is a large body of analysis countering these claims. To summarize, government spending

Fiscal Stimulus Bang for the Buck[27]	Bang for the Buck
Tax Cuts	
Nonrefundable Lump-Sum Tax Rebate	1.01
Refundable Lump-Sum Tax Rebate	1.22
Temporary Tax Cuts	
Payroll Tax Holiday	1.24
Across the Board Tax Cut	1.02
Accelerated Depreciation	0.25
Loss Carryback	0.22
Housing Tax Credit	0.90
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.51
Make Bush Income Tax Cuts Permanent	0.32
Make Dividend and Capital Gains Tax Cuts Permanent	0.37
Cut Corporate Tax Rate	0.32
Spending Increases	
Extending Unemployment Insurance Benefits	1.61
Temporary Federal Financing of Work-Share Programs	1.69
Temporary Increase in Food Stamps	1.74
General Aid to State Governments	1.41
Increased Infrastructure Spending	1.57
Low-Income Home Energy Assistance Program (LIHEAP)	1.13

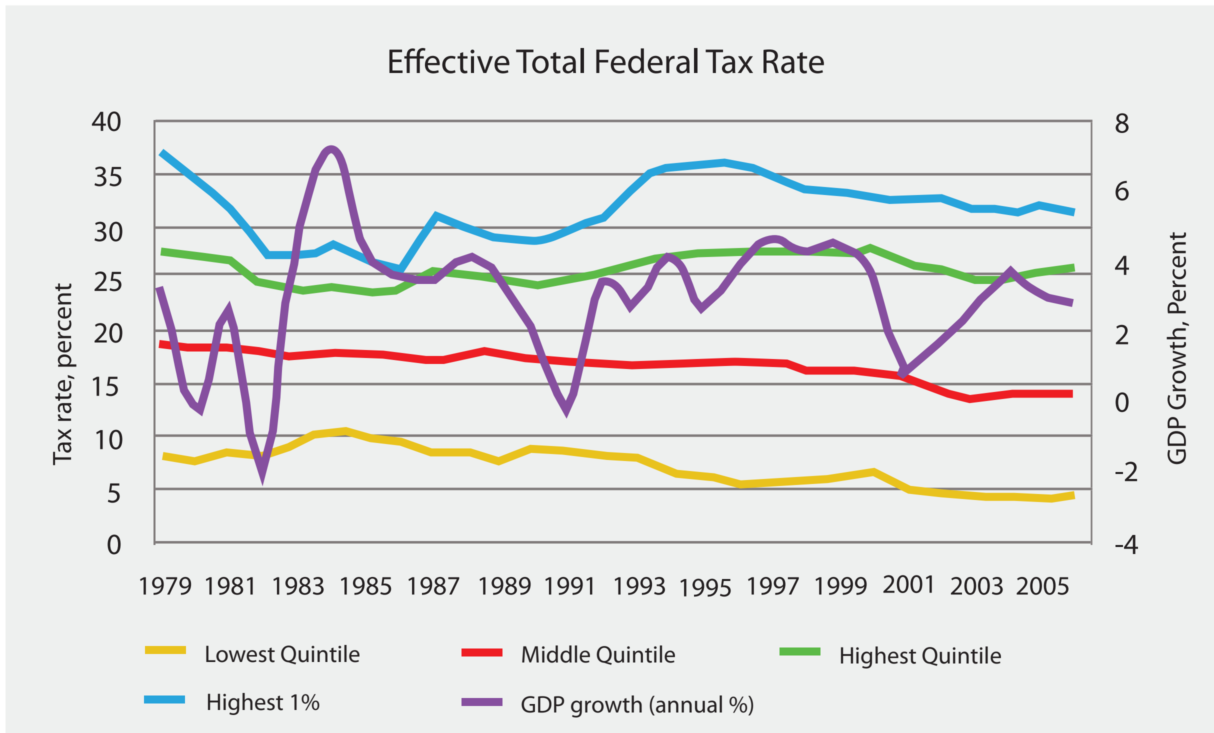
Note: The bang for the buck is estimated by the one-year dollar change in GDP for a given dollar reduction in federal tax revenue or increase in spending.

Source: Moody's Economy.com

can often be more effective as a short-term stimulus than tax cuts. Mark Zandi, chief economist at Moody's Analytics, estimates that each dollar spent increasing government spending on effective programs— extending unemployment benefits, infrastructure projects, and aid to state governments— currently provides a much larger short-term boost to the economy than any tax cut.[26] When the economy

once again begins to grow at normal rates, federal borrowing could force up interest rates. However, in the near future, with conventional monetary policy at its limits and interest rates at historically low levels, deficit-financed public investment may lead to increased private sector investment as government incentives entice businesses to resume spending.. Spending of this sort also has additional benefits: unemployment benefits and food stamps help the poorest members of our society, and infrastructure spending makes our economy more productive in the long-term as well as the short-term. So, by efficiently collecting more revenue and spending the money wisely, the government can both increase growth and achieve other policy goals at the same time.

There is little in the historic record of the US to support the argument that higher tax rates decrease growth. Over the past 30 years, GDP growth has fluctuated widely while tax rates have generally decreased across the income spectrum. In fact, the largest economic expansion of the past 30 years, between 1991 and 2001[28], occurred while tax rates were also at their highest during that period.



Source: Tax Policy Center and Bureau of Economic Analysis

Won't raising taxes on capital gains reduce investment and slow economic growth?

Opponents of raising the capital gains tax rate claim that doing so would stifle investment in the country, affecting everything from stock prices to the availability of loans and significantly reducing growth. However, the tax rate has been significantly higher during recent economic expansions, including a 25 percent rate during the high-growth 1950s and much of the 1960s[29]. That these higher rates did not stifle previous expansions suggests that restoring capital gains tax rates to previous levels would not significantly deter growth today as well. Not only is raising the capital gains tax rate unlikely to slow growth, but it is unlikely to reduce the capital stock in the United States. While a higher capital gains tax rate may cause some investors to creatively avoid taxation, analysts estimate that a higher rate will still result in higher government revenue.

Don’t the rich already pay the majority of taxes? Why should they pay more?

Though the wealthy do pay higher percentages of their income in taxes, they also spend far less of their income on basic necessities: housing, food, utilities, etc. So, a far higher percentage of their income is “disposable”. In addition, the wealthy owe a part of their success to the opportunities provided by this country: the education system, the physical infrastructure, the labor of other hard-working Americans. It therefore seems only right that those fortunate individuals give back to maintain and improve the country that enabled their success.

Won’t raising the corporate income tax force companies to go offshore?

The reality is, many companies are unable to go offshore. The physical realities of many industries—retail, service, etc.—require that they be based where their customers are. Other more mobile industries could potentially choose to go offshore if corporate taxes were raised, but the many costs associated with outsourcing—acquiring a new location, hiring a new labor force, disposing of their American assets—would make moving prohibitively expensive for many. The extremely cheap labor available in other countries may outweigh the costs of outsourcing for some industries, but in most cases, this low-priced labor is kept artificially cheap by the weak labor laws, lack of environmental regulations, and high unemployment in many other countries. In these cases, additional protections should be enacted to ensure that good American jobs don’t disappear simply because easily exploitable workforces are available elsewhere in the world.

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