



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 8, 2005

MEMORANDUM FOR JEFFREY KUPFER, EXECUTIVE DIRECTOR
PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

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SUBJECT BACKGROUND MATERIALS ON THE TAX BURDEN ON
INVESTMENT AND ENTREPRENEURSHIP

Attached are fact sheets prepared by the Treasury Department's Office of Tax Analysis on the tax treatment of savings, tax treatment of investment in human capital, how the tax system affects economic decisions, and the compliance costs of the tax system. We submit these materials as additional background for the hearing the President's Advisory Panel on Federal Tax Reform held on March 16, 2005. These materials should be considered public submissions to the Panel.

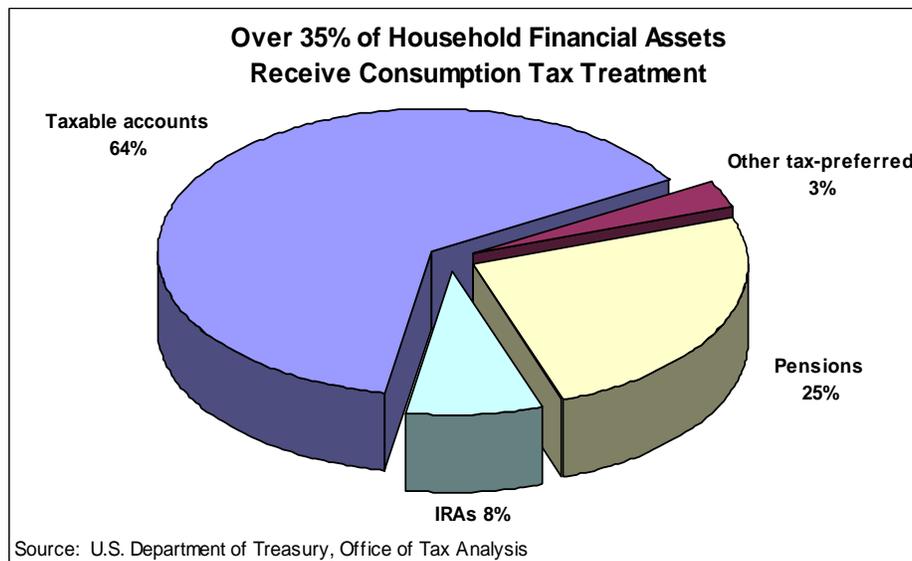
Attachments

Fact Sheet

The Tax Treatment of Savings

The U.S. “income tax” system is more accurately described as a *hybrid* income-consumption tax because it includes elements of both types of taxes. The primary difference between an income and consumption tax is that a tax on consumption does not tax the return to saving (either by excluding from income amounts saved or by explicitly not taxing the yield on saving). Under an income tax people who choose to consume some of their earnings at a later date (e.g., those who save) are taxed more heavily. This discourages future consumption (savings) relative to current consumption.

- Relative to a pure income tax, the current U.S. tax system reduces the tax on the return to saving through tax-preferred savings accounts (e.g., IRAs, pensions, and college savings accounts), faster write-off of investment (e.g., expensing and accelerated depreciation), and lower tax rates on dividends and capital gains.
- As shown below, over one-third of the return on household financial assets is effectively exempt from taxation (excluding the effects of the corporate tax).



Fact Sheet

How are investments in human capital treated under the current law income tax?

Human capital (e.g., education, experience, job skills) is an important input in the production of final goods. The return to investment in human capital is an educated worker's stream of future income. Investing in human capital is a cost of earning income.

- Under a comprehensive income tax, investments in human capital would be capitalized and recovered over the period in which returns to education are earned.
- Under a consumption tax, investment in human capital would be expensed or deducted immediately.

To the extent that they represent consumption rather than investment in human capital, however, education expenses should be taxed under either tax system. In practice, it can be very difficult to distinguish between human capital investment and education consumption.

Under the current income tax system, the tax treatment of education expenses is mixed. Some costs are expensed, while others are subject to varying degrees of taxation.

Examples of education spending that are expensed (excluded or deducted from income) under the income and payroll tax include:

- Earnings that the student would have received if she were working instead of attending school.
- Scholarships, fellowships, and reduced tuition at public colleges and universities.
- Certain education expenses paid by an employer.
- Education expenses paid through a qualified tuition plan (529) or education savings plan.
- Education expenses paid with Treasury bond interest.

Examples of education spending expensed under the income tax include:

- Up to the first \$4,000 of tuition and fees (subject to income limits).
- Certain education expenses paid by an employee.

Examples of income tax treatment unrelated to expensing (credits):

-- *treatment may be more or less favorable than expensing depending on the taxpayer's marginal tax rate and alternative minimum tax (AMT) considerations:*

- The income tax allows a credit of 100% of the first \$1,000 of tuition and fees and 50% of the second \$1,000 of tuition and fees per student in his or her first or second year of postsecondary education, but the credit is not allowed against the AMT after 2005.
- The income tax allows a credit of 20% of the first \$10,000 of tuition and fees per family but the credit is not allowed against the AMT after 2005.

Example of taxable spending on education:

- Education expenses paid with taxable earnings or taxable savings that do not qualify for deductions or credits because of income limits or other limitations.

Fact Sheet

How Do Taxpayers Respond to Tax Rates?

The tax system affects a multitude of household and business decisions and can result in the inefficient use of economic resources, substantial economic waste, and, ultimately, lower real incomes. Higher tax rates can discourage work effort, entrepreneurial activity, and saving. Higher tax rates can also affect in what types of assets individuals invest (e.g., lower-yielding tax-exempt or tax-preferred assets), encourage consumption of tax-deductible items, and lead to greater tax avoidance and evasion, which can undermine voluntary compliance.

Overall Response to Higher Taxes

Many of the ways individuals respond to changes in taxes can be summarized in a single statistic by considering how changes in tax rates affect taxable incomes. Both the Congressional Budget Office and the *2003 Economic Report of the President* suggest that a reasonable estimate is that a 1 percent decrease in the after-tax return to a taxpayer induces about a 0.4 percent decline in their taxable income. This statistic captures a wide range of responses including changes in labor supply, fringe benefits, investment portfolios, charitable giving, home mortgage debt, etc. It excludes, however, some longer term responses related to changes in savings and the stock of capital.

- To illustrate the significance of this estimate, consider a taxpayer in the 33 percent tax bracket with \$300,000 of taxable income (shown in the table to right). Increasing the tax rate from 33 to 36 percent would reduce after-tax returns in that bracket by 4.5 percent – from 67 cents to 64 cents per dollar (ignoring any other taxes that apply to the income).
- Using the 0.4 measure of responsiveness, the taxpayer would respond by reducing his/her taxable income by about 1.8 percent. For this hypothetical taxpayer, it can be shown that for every dollar of revenue absent this behavioral response (e.g., under a “static” analysis ignoring any behavioral response), as much as 55 cents could be lost due to the various ways taxpayers respond to the higher tax rates.¹

Higher Tax Rates Reduce Reported Incomes An Example: Increase the 33% Tax Rate to 36%

Effect of higher tax rate assuming no change in taxpayer's reported income

Taxpayer with \$300,000 in income	300,000
Initial tax (on income in top tax bracket)	38,676
Tax at higher 36% tax rate (on income in top tax bracket) assuming no change in taxpayer's income	42,192
Higher tax paid	3,516

Higher tax rate causes taxpayer to rearrange affairs and report less income

Increase in tax rate from 33% to 36% reduces after-tax return by:	-4.5%
Reduction in taxpayer's income due to higher tax rate: 1/	-5,373
New level of income	294,627
Tax at higher 36% tax rate (on income in top tax bracket) after response to higher tax rate	40,258
Tax lost due to taxpayer's response to higher tax rate	-1,934
Percent of tax lost due to behavioral response	-55%

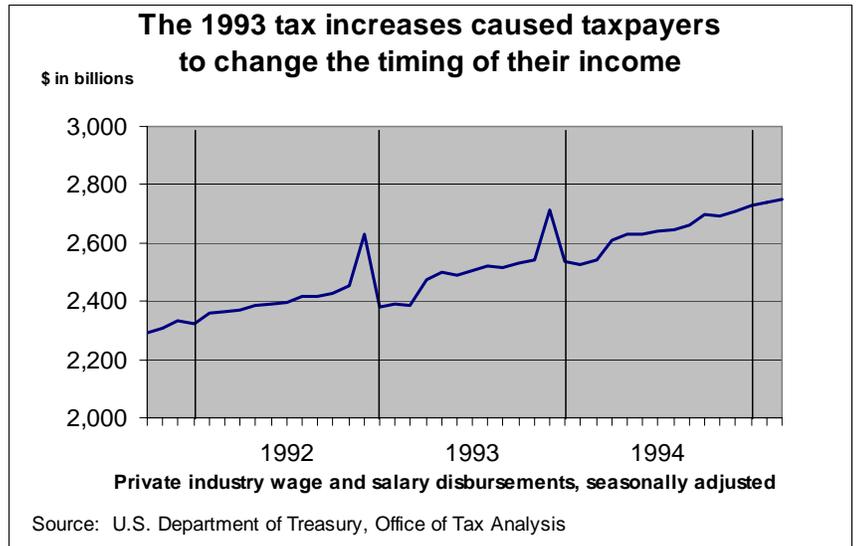
1/ Reduction in the taxpayer's income assumes that for every 1 percent decline in the after-tax return to the taxpayer induces a 0.4 percent decline in their taxable income.

Source: U.S. Department of the Treasury, Office of Tax Analysis.

¹ In this example, the taxpayer initially pays \$38,676 in tax on \$117,200 of taxable income in the 33 percent tax bracket (\$300,000 less \$182,800 in lower tax brackets). When the tax rate is increased to 36 percent, the taxpayer

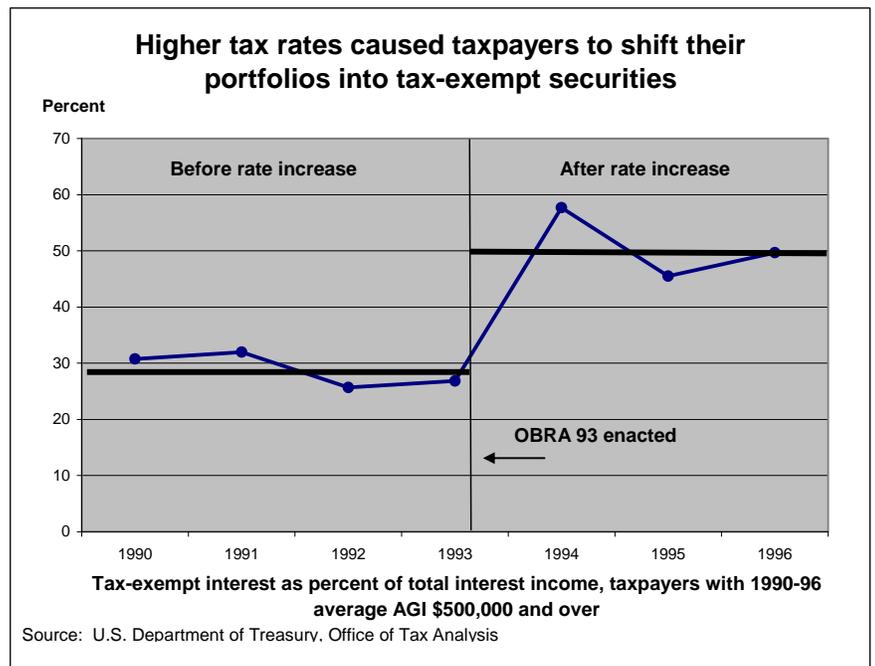
Changes in the Form of Income

The higher tax rates enacted in the 1990s provide an opportunity to consider some specific effects of taxes on taxpayers' decisions, such as the composition of their investment portfolios. The 1993 tax rate increases, for example, caused high-income taxpayers to shift their investment portfolios toward tax-exempt investments. As shown in the chart to the right, the tax-exempt interest of high-income taxpayers increased from about 30 percent to about 50 percent of total interest income. These taxpayers also likely shifted from taxable investments to non-dividend-paying stocks and tax-preferred retirement accounts. High tax rates thus cause taxpayers to engage in otherwise unnecessary tax avoidance activity. Increasing tax rates can also affect how much taxpayers save and invest, when they retire, and how much they work.



Changes in Timing of Income

Another way taxpayers respond to higher tax rates is to change the *timing* of income and deductions. As illustrated in the chart to the right, high-income taxpayers accelerated the receipt of wages and year-end bonuses from 1993 to 1992 – over \$15 billion – in order to avoid the effects of the anticipated increase in the top rate from 31 percent to 39.6 percent. At the end of 1993, taxpayers shifted wages and bonuses yet again to avoid the increase in Medicare taxes that went into effect beginning in 1994. Taxpayers also shifted other income and delayed their charitable donations and other deductions in anticipation of higher tax rates.



reduces her taxable income by about 1.8 percent (0.4 times the 4.5 percent reduction in the after-tax return), from \$300,000 to \$294,627. After this response, the taxpayer pays \$40,258 in tax at the 36 percent rate on \$294,627 of taxable income in that bracket (note that the income in the lower brackets is still taxed at the original rates). With no response, the taxpayer would have paid \$42,192 at the 36 percent rate. Thus, the taxpayer paid \$1,582 more in tax after the behavior response, but would have paid \$3,516 more in tax with no response.

Fact Sheet

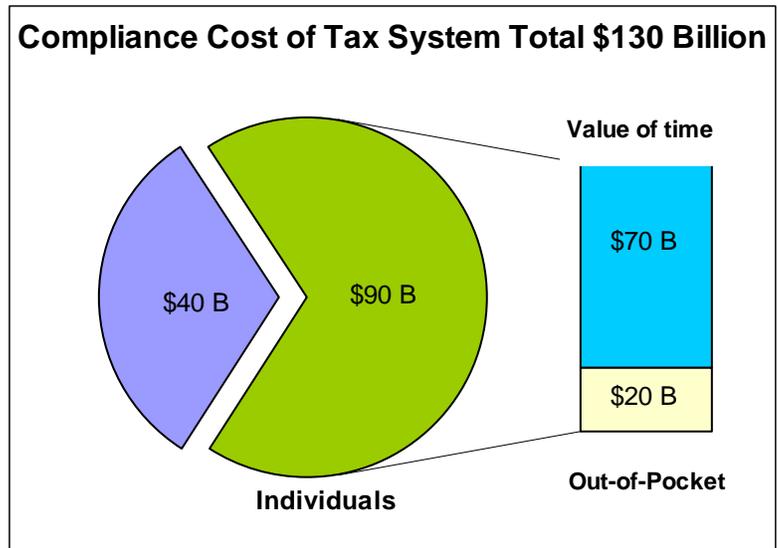
What are the Costs of Complying with the Federal Income Tax System?

The U.S. tax system not only imposes a cost to the economy by distorting households' and businesses' economic decisions and slowing economic growth, but it also imposes a cost measured by the value of the time and resources devoted to complying with the tax system that could be put to more productive uses with a simpler tax system. According to the IRS, business and individual taxpayers spend more than 6 billion hours* per year to comply with the tax system. Some research places the total compliance costs of the income tax at roughly \$130 billion** annually – about 13 cents for every dollar in income tax revenues collected.

These compliance costs include both out-of-pocket costs and the time taxpayers spend to learn about the tax laws, keep and assemble necessary records, and prepare and submit tax returns.

Individual taxpayers (including sole proprietors) spent roughly 3.5 billion hours* to comply with the tax system – the equivalent of a million and a half “hidden” IRS employees. According to a recent study based on IRS data,

- Compliance costs for individuals totaled roughly \$90 billion.
- On average, individuals spend 26 hours on their taxes.
- On average, taxpayers spent \$157 per return on out-of-pocket costs for the services of tax professionals, filing fees, software purchases, etc. in tax year 2002.
- Taxpayers with self-employment income tend to have more complex affairs and spend more time on their taxes.
 - The 98 million taxpayers with no self-employment income spent about 15 hours and \$76 in out-of-pocket costs.
 - The 35 million taxpayers with self-employment income or employee business expenses averaged about 59 hours and spent \$384 in out-of-pocket costs.



Businesses spent over 3 billion hours* complying with the tax system at a total cost of roughly \$40 billion** annually.

- Recent academic research indicates that compliance costs are the highest for the very largest businesses. Those with over \$5 million in assets reported compliance costs of nearly \$25 billion per year.
- If sole proprietors are counted with businesses, the compliance costs would be nearly evenly shared by businesses and individuals.

* Estimates from Internal Revenue Service. ** Estimates from Testimony by Professor Joel Slemrod, University of Michigan, before the President's Advisory Panel on Federal Tax Reform, March 3, 2005.