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# Tax Reform: Simplification is Good Policy

Antony Davies  
Duquesne University

September 27, 2013

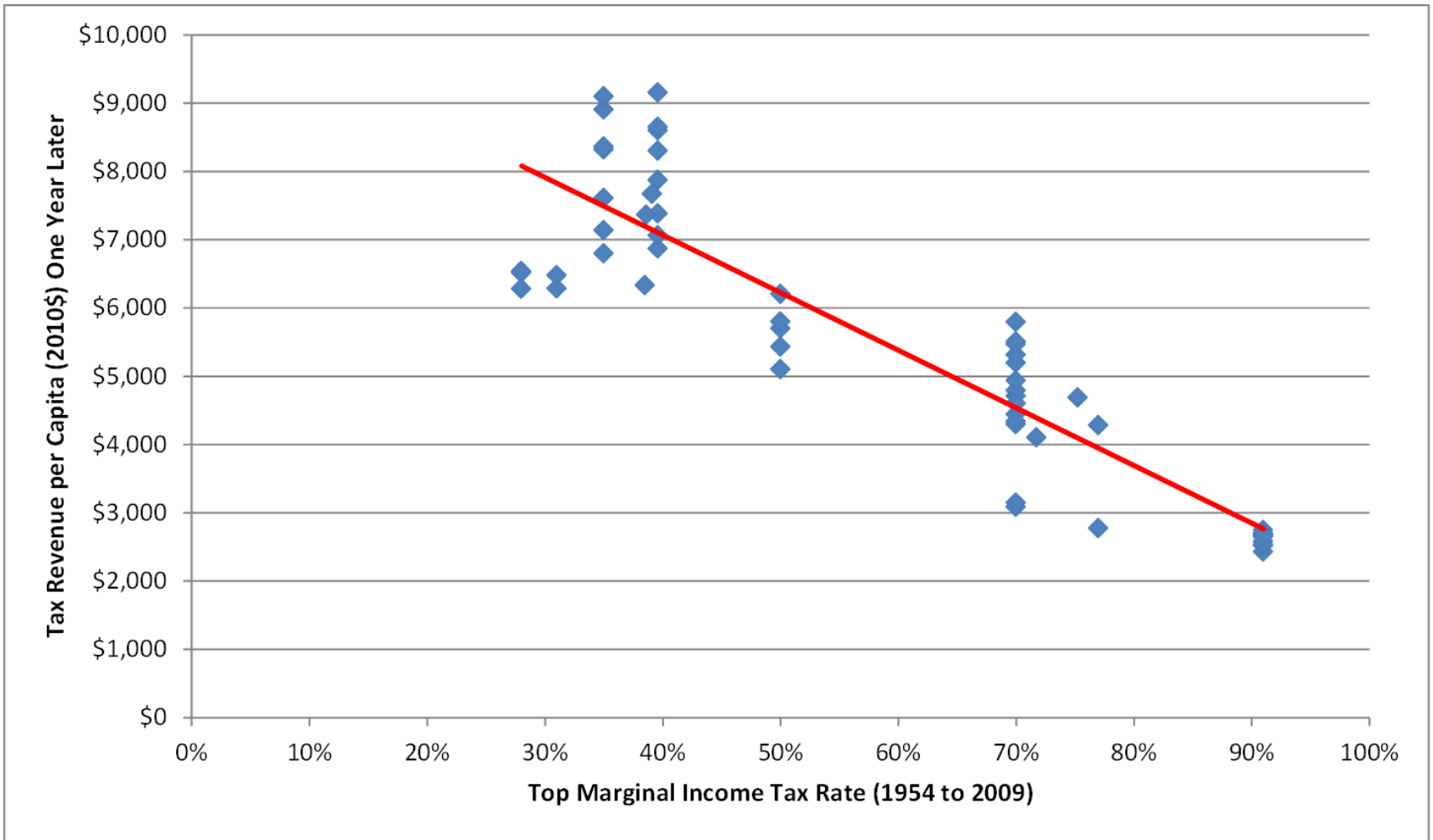
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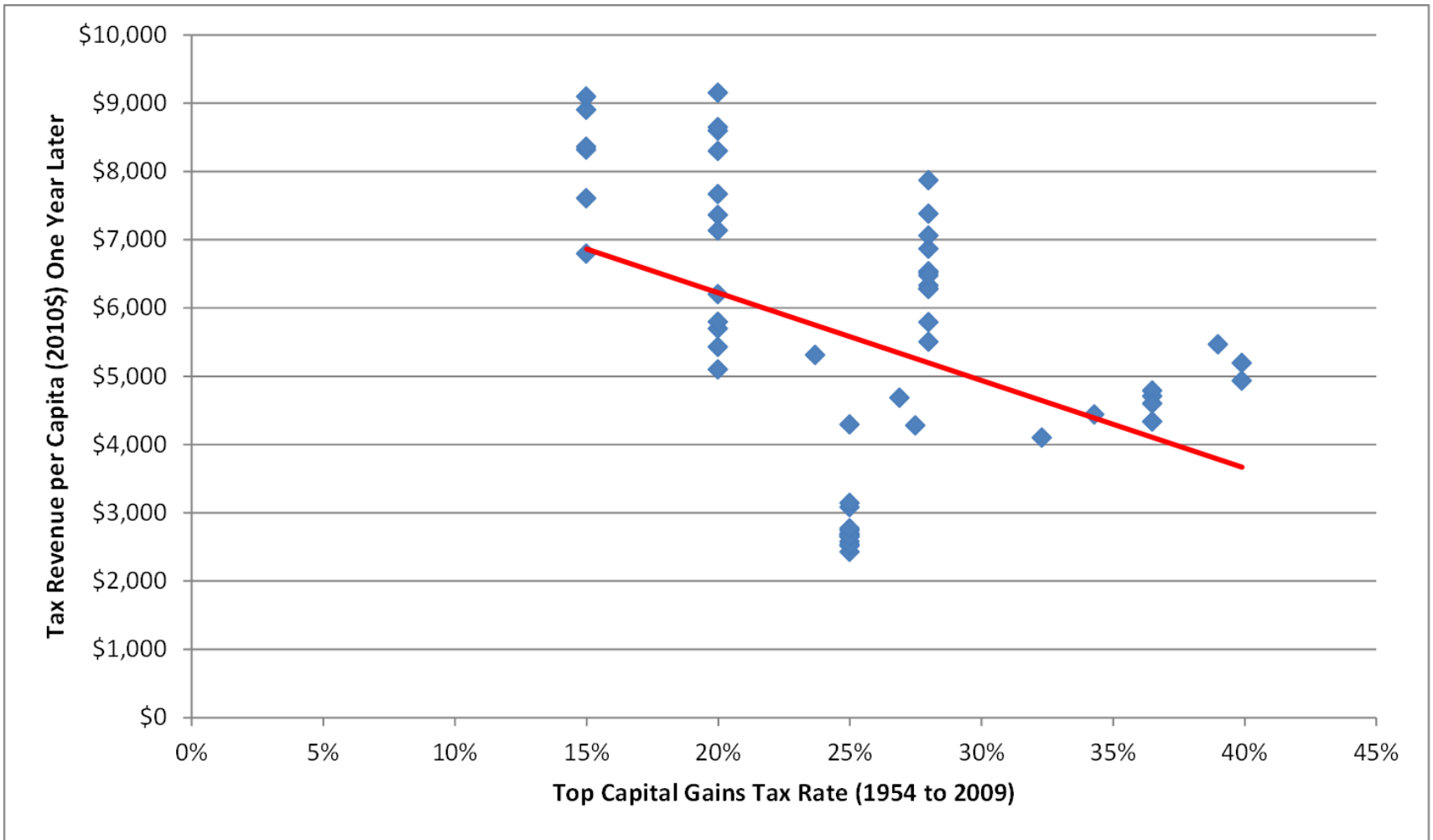
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# Tax Rates versus Tax Revenues



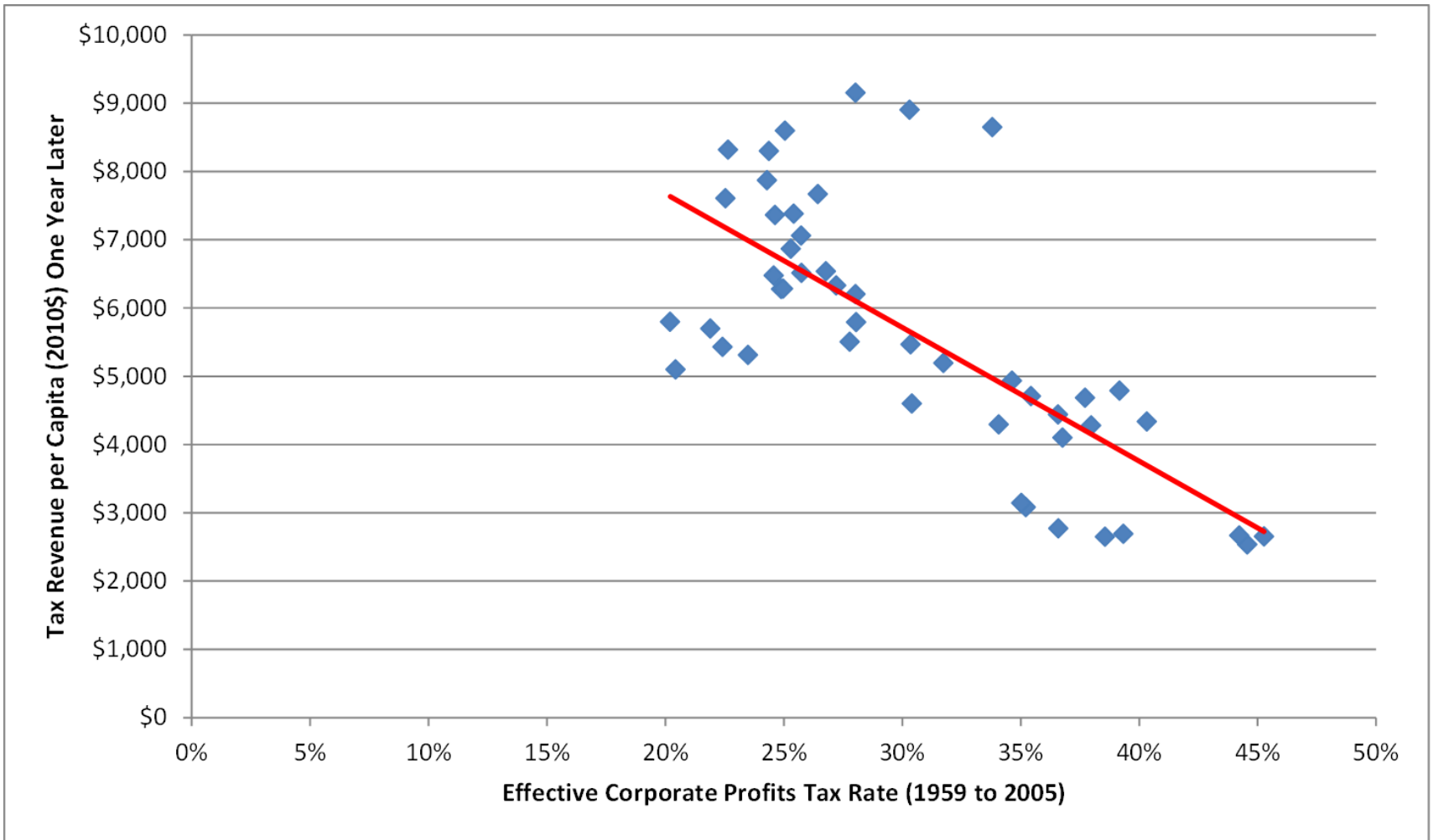
Source: Tax Policy Center (Urban Institute and Brookings Institute), Bureau of Economic Analysis  
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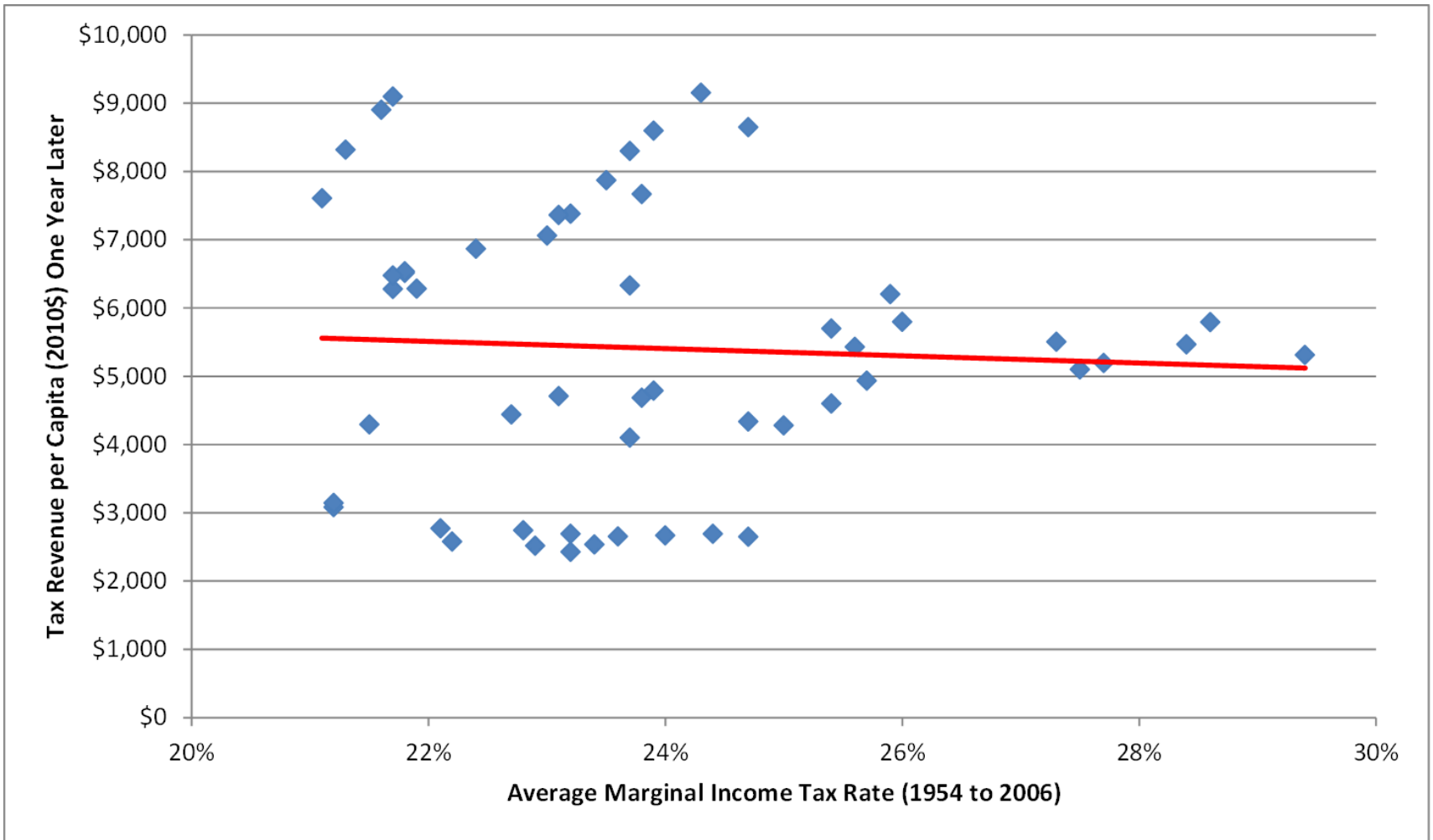
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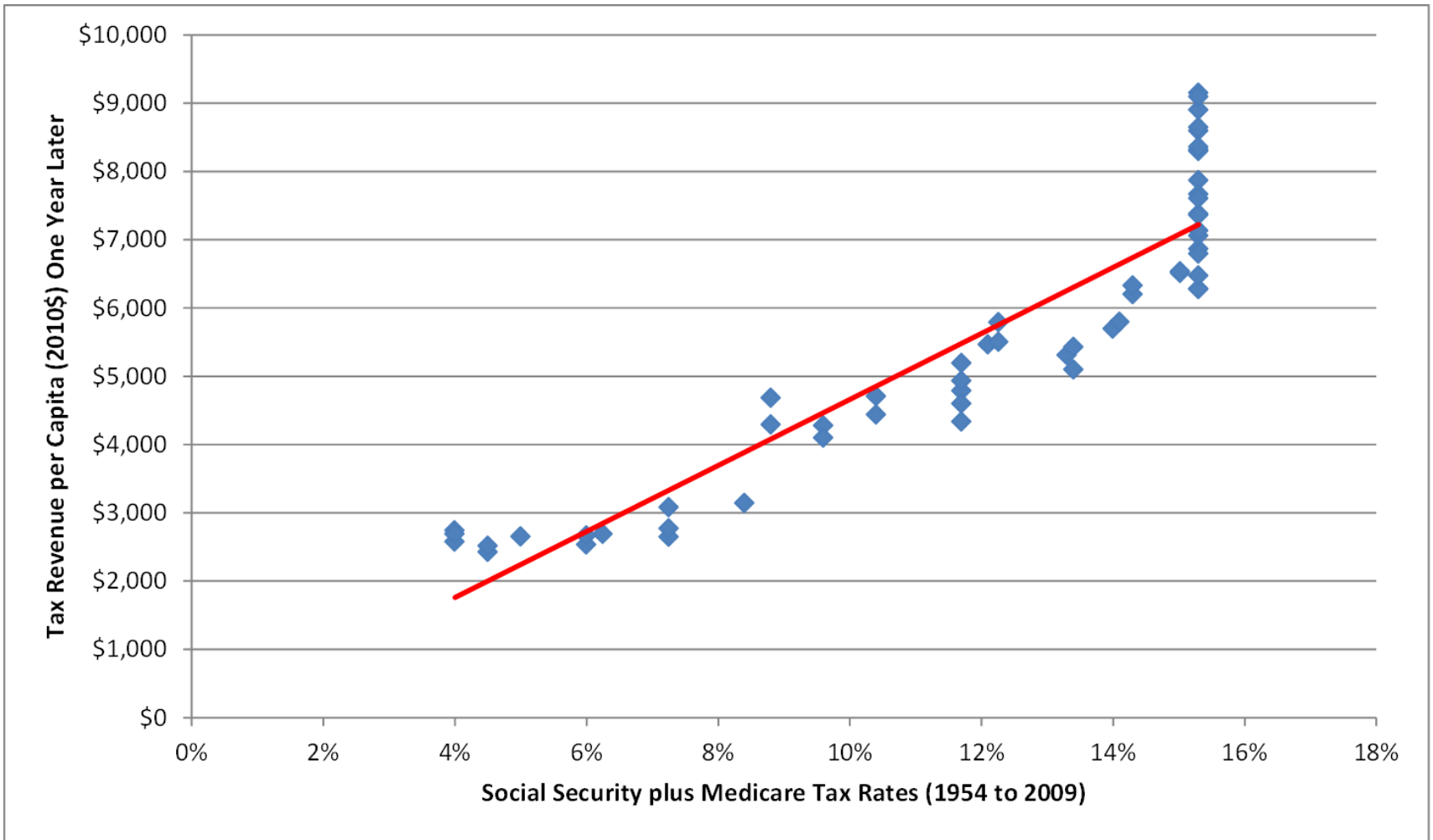


Source: Tax Policy Center (Urban Institute and Brookings Institute), Bureau of Economic Analysis, Barro and Redlick (2009)

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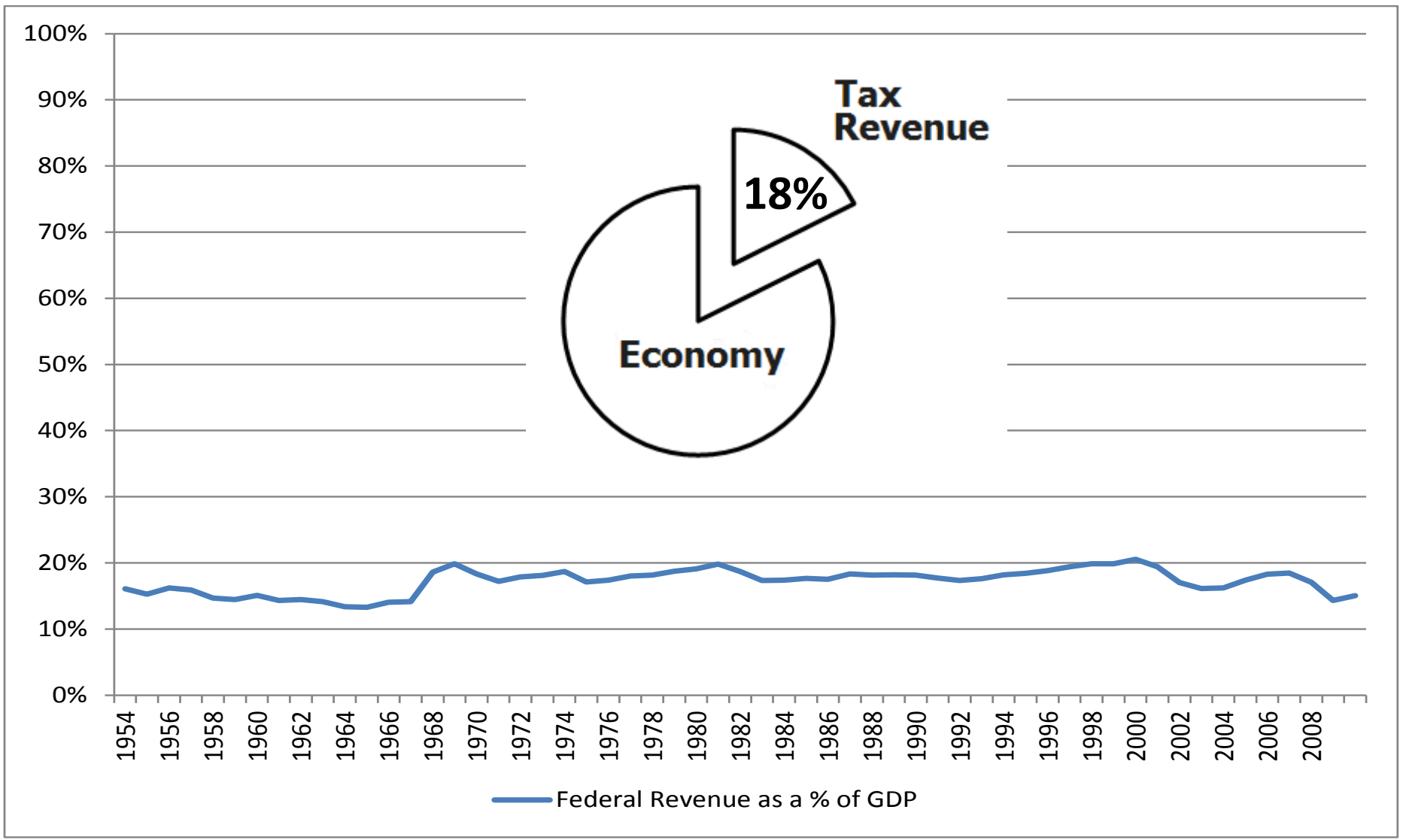


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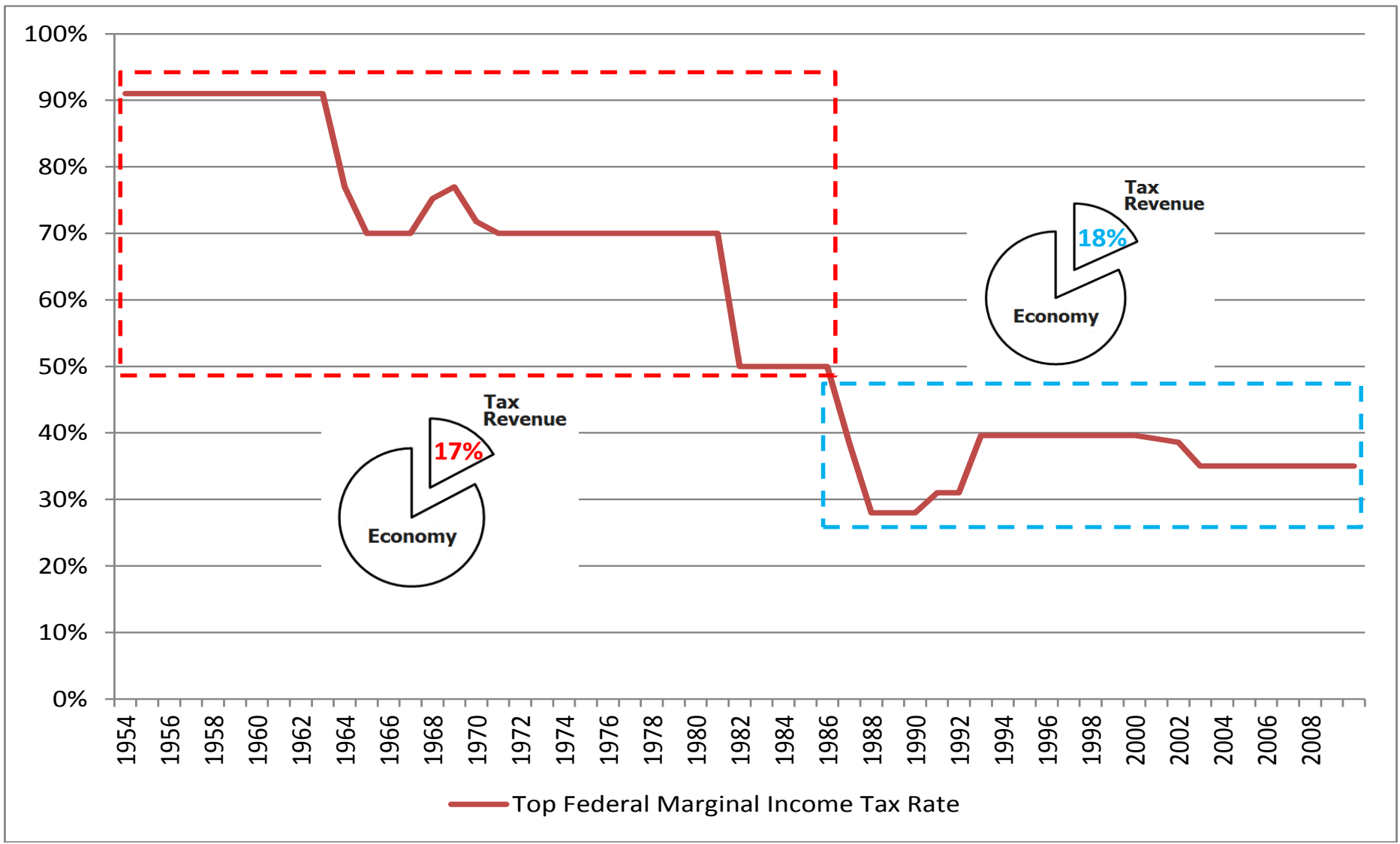


Data Source: Internal Revenue Service, Bureau of the Census



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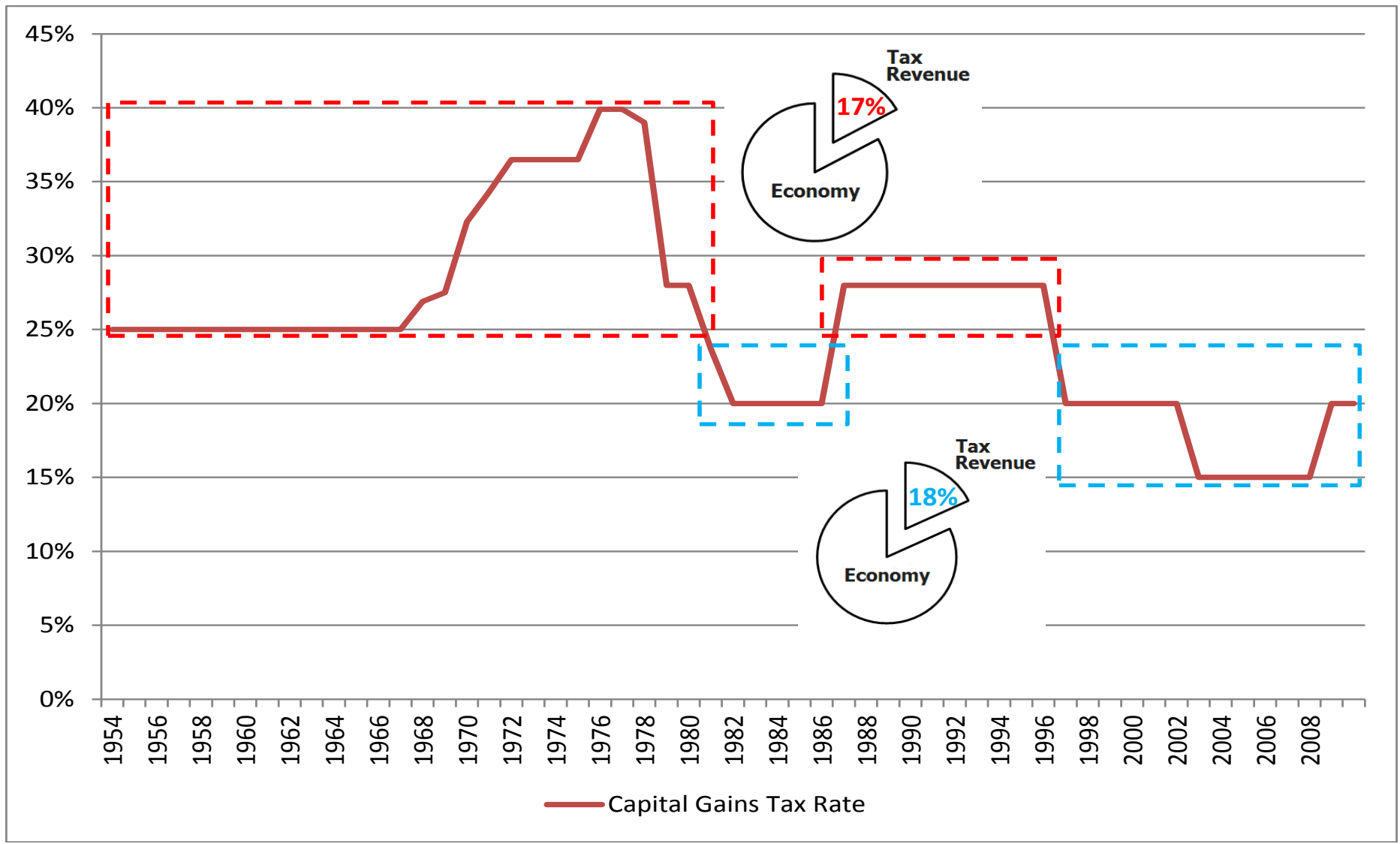




Data Source: Internal Revenue Service, Bureau of the Census



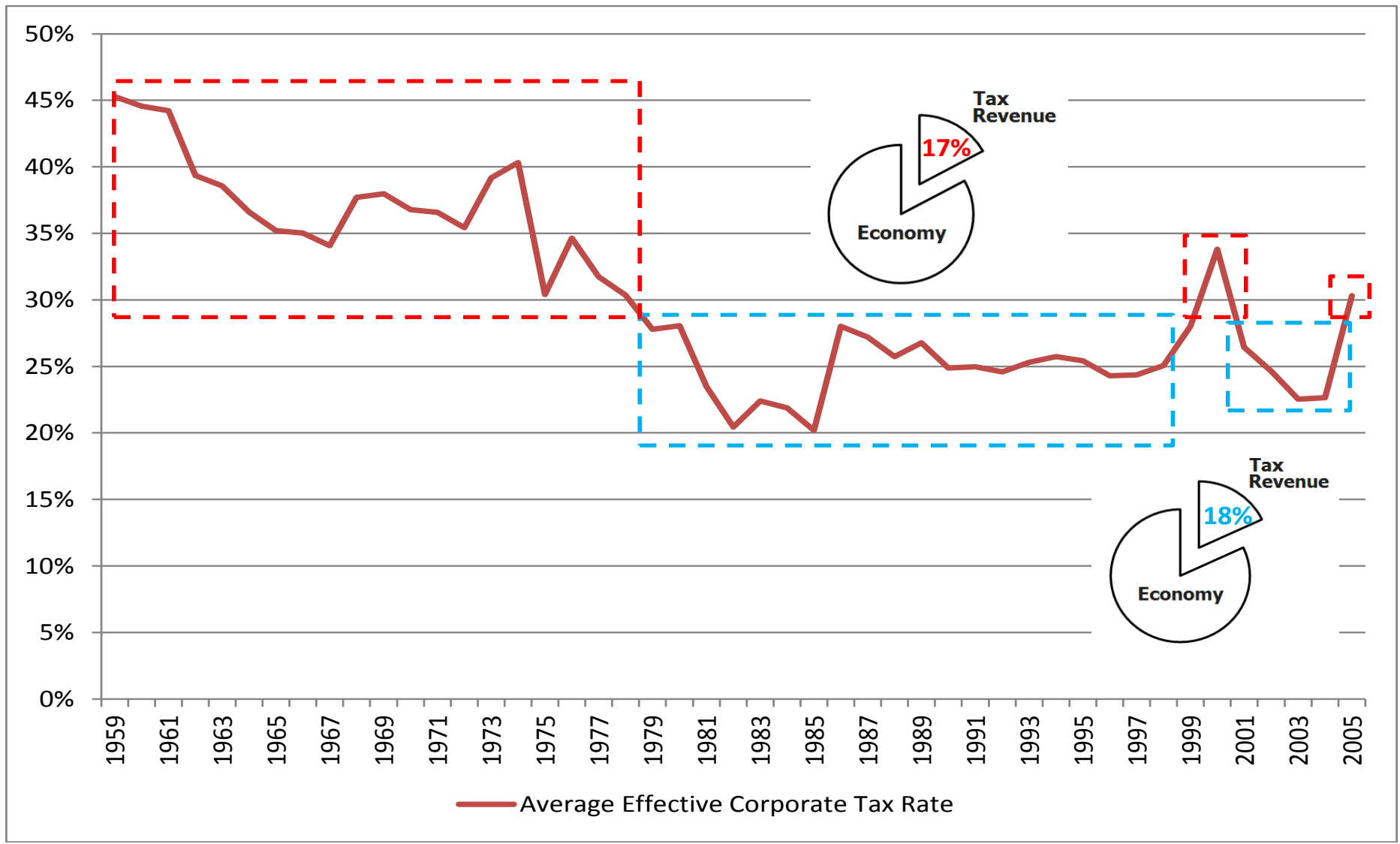
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Data Source: Internal Revenue Service, Bureau of the Census



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Data Source: Internal Revenue Service, Bureau of the Census



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# Fair Shares: Who pays the most taxes?



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# Distribution of Federal Taxes (all taxes combined)

Income Category	Income Before Taxes & Transfers (per household)	Federal Taxes (per household)	Average Tax Rate (ignore transfers)
Bottom Quintile	\$15,000	\$200	1%
Second Quintile	\$28,700	\$2,900	10%
Middle Quintile	\$48,900	\$7,200	15%
Fourth Quintile	\$79,900	\$14,100	18%
81% to 90%	\$120,700	\$24,700	20%
91% to 95%	\$164,800	\$37,000	22%
96% to 99%	\$262,200	\$65,600	25%
Top 1%	\$1,209,200	\$353,000	29%

Data Source: Congressional Budget Office

Top 1% person's  
income

= 25 x

Middle-income  
person's income

Top 1% person's  
tax bill

= 49 x

Middle-income  
person's tax bill



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# Distribution of Federal Taxes (all taxes combined)

Income Category	Income Before Taxes & Transfers (per household)	Federal Taxes (per household)	Average Tax Rate (ignore transfers)	Average Tax Rate (include transfers)
Bottom Quintile	\$15,000	\$200	1%	-55%
Second Quintile	\$28,700	\$2,900	10%	-41%
Middle Quintile	\$48,900	\$7,200	15%	-17%
Fourth Quintile	\$79,900	\$14,100	18%	0%
81% to 90%	\$120,700	\$24,700	20%	11%
91% to 95%	\$164,800	\$37,000	22%	16%
96% to 99%	\$262,200	\$65,600	25%	21%
Top 1%	\$1,209,200	\$353,000	29%	28%

*Data Source: Congressional Budget Office*

After accounting for transfers, the top 20% (on average) are the only people paying federal taxes.



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# Whom Do You Want to Tax?

Income Category	Minimum Income	Average Tax Rate (ignore transfers)	Federal Taxes	Income After Taxes & Transfers (per household)	Federal Tax Revenue
Bottom Quintile	\$0	1.3%	\$200	\$23,300	\$4,540,000,000
Second Quintile	\$20,000	10.1%	\$2,900	\$40,500	\$68,440,000,000
Middle Quintile	\$40,000	14.7%	\$7,200	\$57,100	\$170,640,000,000
Fourth Quintile	\$65,000	17.6%	\$14,100	\$79,700	\$328,530,000,000
81% to 90%	\$100,000	20.5%	\$24,700	\$107,100	\$291,460,000,000
91% to 95%	\$140,000	22.5%	\$37,000	\$138,800	\$218,300,000,000
96% to 99%	\$200,000	25.0%	\$65,600	\$206,200	\$314,880,000,000
Top 1%	\$340,000	29.2%	\$353,000	\$866,700	\$388,300,000,000
				<b>New Income Tax Revenue</b>	<b>\$1,785,090,000,000</b>
				<b>New Deficit</b>	<b>\$1,400,000,000,000</b>

*Data Source: Congressional Budget Office*



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# 2012

How much government spending do people fund with their tax dollars?

- Top 1% 56 days
- 2% to 5% 44 days
- 5% to 10% 31 days
- 10% to 20% 41 days
- 20% to 40% 47 days
- 40% to 60% 24 days
- 60% to 80% 10 days
- 80% to 100% 18 hours

Children 112 days



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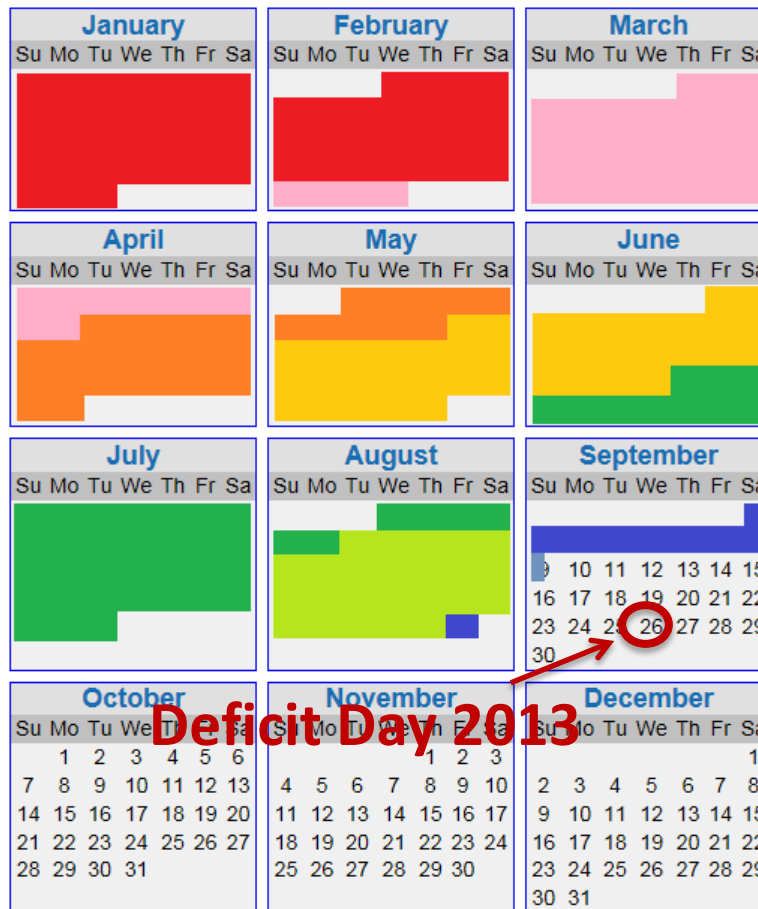


# 2013

How much government spending do people fund with their tax dollars?

- Top 1% 59 days
- 2% to 5% 46 days
- 5% to 10% 33 days
- 10% to 20% 43 days
- 20% to 40% 50 days
- 40% to 60% 25 days
- 60% to 80% 11 days
- 80% to 100% 18 hours

Children 97 days



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The larger economic problem involves the “not yet” rich.



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**Average Rates Influence Tax Revenue**

**Marginal Rates Influence People's  
Behavior**



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<u>Income Bracket</u>	<u>Marginal Rate</u>
\$0 to \$25,000	5%
\$25,001 to \$50,000	10%
\$50,001 to \$75,000	90%

You are earn \$50,000

Tax bill: \$3,750

Average tax rate:  $\$3,750 / \$50,000$ : 7.5%

Accept a \$5,000 raise?

The person's average rate is 7.5%

His marginal rate is 90%

<u>Income Bracket</u>	<u>Marginal Rate</u>
\$0 to \$25,000	5%
\$25,001 to \$50,000	10%
\$50,001 to \$75,000	90%

After taxes, the raise is worth \$500.

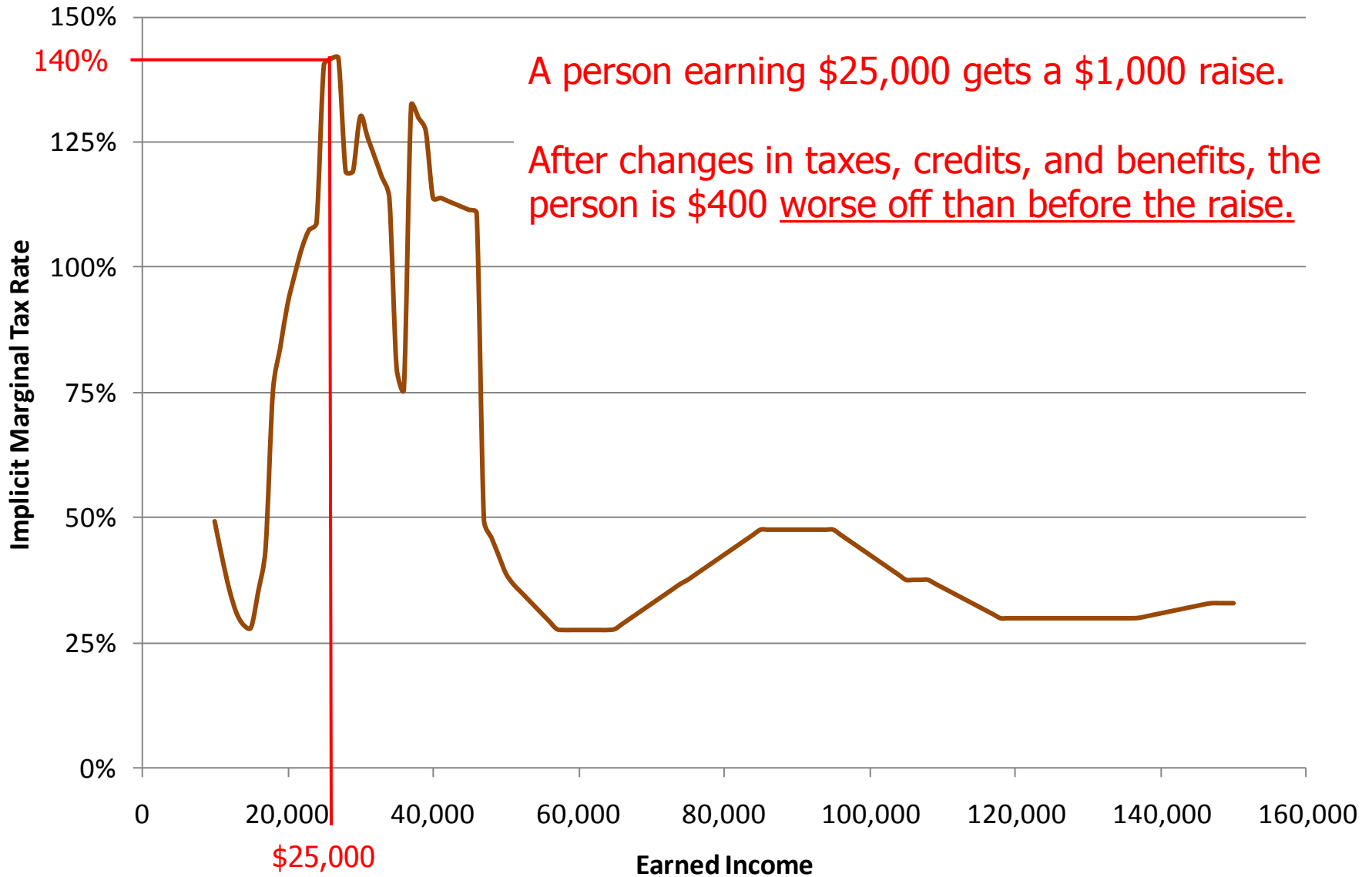
When deciding whether to accept the raise, the 7.5% average rate is irrelevant. What matters is the 90% marginal rate.

Average rates look backward. Marginal rates look forward.



# Implicit Marginal Tax Rates

defined as:  $1 - (\text{change in Income} - \text{Taxes} + \text{Subsidies}) / (\text{change in Earned Income})$



# Implicit Marginal Tax Rates

defined as:  $1 - (\text{change in Income} - \text{Taxes} + \text{Subsidies}) / (\text{change in Earned Income})$



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# Complexity is the Enemy



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## Why Does Complexity Matter?

- Special interests can hide the fact that they are co-opting the tax code.
- Cost of compliance is \$600 billion (Fichtner and Feldman).
- Makes criminals out of honest people.
- Lose the ability to incent behavior.



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# Conclusion



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## Conclusion

- Government controls tax rates, not tax revenue.
- Historically, federal government has collected 18% of the economy, regardless of tax rates.
- All tax cuts are for the rich because the rich are the only people paying (net) taxes.
- Better solution is to tax all income at 18% with no deductions, exemptions, credits, or loopholes.



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