The New York Times

The Opinion Pages | OP-ED CONTRIBUTOR

Stop Coddling the Super-Rich

By WARREN E. BUFFETT AUG. 14, 2011

Omaha

OUR leaders have asked for “shared sacrifice.” But when they did the asking, they spared me. I checked with my mega-rich friends to learn what pain they were expecting. They, too, were left untouched.

While the poor and middle class fight for us in Afghanistan, and while most Americans struggle to make ends meet, we mega-rich continue to get our extraordinary tax breaks. Some of us are investment managers who earn billions from our daily labors but are allowed to classify our income as “carried interest,” thereby getting a bargain 15 percent tax rate. Others own stock index futures for 10 minutes and have 60 percent of their gain taxed at 15 percent, as if they’d been long-term investors.

These and other blessings are showered upon us by legislators in Washington who feel compelled to protect us, much as if we were spotted owls or some other endangered species. It’s nice to have friends in high places.

Last year my federal tax bill — the income tax I paid, as well as payroll taxes paid by me and on my behalf — was $6,938,744. That sounds like a lot of money. But what I paid was only 17.4 percent of my taxable income — and that’s actually a lower percentage than was paid by any of the other 20 people in our office. Their tax burdens ranged from 33 percent to 41 percent and averaged 36 percent.

If you make money with money, as some of my super-rich friends do, your percentage may be a bit lower than mine. But if you earn money from a job, your percentage will surely exceed mine — most likely by a lot.

To understand why, you need to examine the sources of government revenue. Last year about 80 percent of these revenues came from personal income taxes and payroll taxes. The mega-rich pay income taxes at a rate of 15 percent on most of their earnings but pay practically nothing in payroll taxes. It's a different story for the middle class: typically, they fall into the 15 percent and 25 percent income tax brackets, and then are hit with heavy payroll taxes to boot.

Back in the 1980s and 1990s, tax rates for the rich were far higher, and my percentage rate was in the middle of the pack. According to a theory I sometimes hear, I should have thrown a fit and refused to invest because of the elevated tax rates on capital gains and dividends.

I didn't refuse, nor did others. I have worked with investors for 60 years and I have yet to see anyone — not even when capital gains rates were 39.9 percent in 1976-77 — shy away from a sensible investment because of the tax rate on the potential gain. People invest to make money, and potential taxes have never scared them off. And to those who argue that higher rates hurt job creation, I would note that a net of nearly 40 million jobs were added between 1980 and 2000. You know what's happened since then: lower tax rates and far lower job creation.

Since 1992, the I.R.S. has compiled data from the returns of the 400 Americans reporting the largest income. In 1992, the top 400 had aggregate taxable income of $16.9 billion and paid federal taxes of 29.2 percent on that sum. In 2008, the aggregate income of the highest 400 had soared to $90.9 billion — a staggering $227.4 million on average — but the rate paid had fallen to 21.5 percent.

The taxes I refer to here include only federal income tax, but you can be sure that any payroll tax for the 400 was inconsequential compared to income. In fact, 88 of the 400 in 2008 reported no wages at all, though every one of them reported capital gains. Some of my brethren may shun work but they all like to invest. (I can relate to that.)

I know well many of the mega-rich and, by and large, they are very decent people. They love America and appreciate the opportunity this country has given them. Many have joined the Giving Pledge, promising to give most of their wealth to philanthropy. Most wouldn't mind being told to pay more in taxes as well, particularly when so many of their fellow citizens are truly suffering.

Twelve members of Congress will soon take on the crucial job of rearranging our country's finances. They've been instructed to devise a plan that reduces the

10-year deficit by at least $1.5 trillion. It's vital, however, that they achieve far more than that. Americans are rapidly losing faith in the ability of Congress to deal with our country's fiscal problems. Only action that is immediate, real and very substantial will prevent that doubt from morphing into hopelessness. That feeling can create its own reality.

Job one for the 12 is to pare down some future promises that even a rich America can't fulfill. Big money must be saved here. The 12 should then turn to the issue of revenues. I would leave rates for 99.7 percent of taxpayers unchanged and continue the current 2-percentage-point reduction in the employee contribution to the payroll tax. This cut helps the poor and the middle class, who need every break they can get.

But for those making more than $1 million — there were 236,883 such households in 2009 — I would raise rates immediately on taxable income in excess of $1 million, including, of course, dividends and capital gains. And for those who make $10 million or more — there were 8,274 in 2009 — I would suggest an additional increase in rate.

My friends and I have been coddled long enough by a billionaire-friendly Congress. It's time for our government to get serious about shared sacrifice.

Warren E. Buffett is the chairman and chief executive of Berkshire Hathaway.

A version of this op-ed appears in print on August 15, 2011, on page A21 of the New York edition with the headline: Stop Coddling the Super-Rich.

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Why Raising Taxes On The Rich Is Important

Joseph Thorndike (http://blogs.forbes.com/people/josephthorndike/) , Contributor

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Over the last decade or so, economist Thomas Piketty has made his name central to serious discussions of inequality. Along with his frequent collaborator, Emmanuel Saez, he has provided the empirical foundation for most political arguments about the danger of growing wealth and income disparities.

Now, Piketty, who teaches at the Paris School of Economics, has published a new book, *Capital in the Twenty-First Century* (http://www.hup.harvard.edu/catalog.php?isbn=9780674430006&content=bios_). In it, Piketty expands upon his empirical work of the last 10 years, while also setting forth a political theory of inequality. This last element of the book gives special attention to tax policy and makes some provocative suggestions — new and higher taxes on the very rich.

Piketty devotes considerable attention to the role of the income tax in ameliorating inequality. He observes, among other things, that income taxes in the modern fiscal state often tend to be roughly proportional, rather than steeply progressive. "This is not surprising," he writes. "It is impossible to tax half of national income to finance an ambitious program of social entitlements without asking everyone to make a substantial contribution."

(This point seems particularly apt for explanations of European tax policy, in which welfare states are large and tax revenue, measured as a share of GDP, tends to range from the OECD average of 36 percent up to nearly 50 percent (France comes in around 45 percent). Its explanatory power is somewhat less compelling in the United States, where the tax burden is generally lower and the welfare state considerably smaller.)

But even when proportional, Piketty insists, income taxes (and other progressive levies) are still an important weapon in the battle to remedy – or at least slow – surging inequality. Even if taxation overall is proportional, he argues, that doesn't mean that tax burdens are proportional through every income range. And when rates are progressive near the top, they can make a real difference in altering "the structure of inequality."

In particular, Piketty argues that progressive taxes on the rich helped keep inequality in check during the decades after World War II. "The evidence suggests that progressive taxation of very high incomes and very large estates partly explains why the concentration of wealth never regained its astronomic Belle Époque levels after the shocks of 1914-1945." And conversely, the decline in high bracket rates since the 1980s — a phenomenon particularly evident in the United States and Great Britain — has helped boost incomes for the very rich in both countries. Piketty goes on to suggest that in many countries, rates may eventually become regressive near the top of the income scale – except in countries where they already have.

There are many problems that might flow from the phenomenon of high-bracket tax relief, particularly if it is allowed to continue. But the worst may be a decline in fiscal consent, defined as the willingness of the population to actually pay their taxes. "Clearly such a fiscal secession of the wealthiest citizens could potentially do great damage to fiscal consent in general," Piketty writes. "Consensus support for the fiscal and social state, which is already

gave-up-on-tax-reform-it-actually-happened/)
Joseph Thorndike
Contributor
(http://www.forbes.com/sites/taxanalysts/)

fragile in a period of low growth, would be further reduced, especially among the middle class, who would naturally find it difficult to accept that they should pay more than the upper class."

Piketty is on to something here, but it's not a new thing. Indeed, it goes to the much maligned notion of making sure that everyone pays a "fair share" of the overall tax burden. This concern was central to the formulation and enactment of American tax policy during the postwar decades. It was a direct outgrowth of the New Deal insistence that burdens be distributed more progressively — not principally for the sake of raising revenue, but for keeping the tax system fair.

The modern American fiscal state is predicated on a bargain. During World War II, lawmakers were forced to expand the personal income tax to help pay for the fighting. Over the course of just a few years, they added millions of middle-class Americans to the tax rolls for the first time, transforming the income tax from a rich man's burden to a middle-class millstone. In return, however, these same lawmakers offered the middle class an implicit (and sometimes nearly explicit) guarantee — rich people would be asked to pony up, too. The steeply progressive wartime rate schedule was the statutory manifestation of this bargain. Taxing superwealthy Americans at 94 percent was not intended to raise a lot of money, at least not directly. Rather, it was designed to ensure that money could be raised from taxpayers in the lower brackets, who would agree to new tax burdens as long as rich Americans were taking it on the chin at the same time.

This bargain proved both effective and durable — as evidenced by the persistence of high tax rates throughout the supposedly conservative 1950s and well into the 1960s. Indeed, the legacy of those rates was still much in evidence until Ronald Reagan pushed through his landmark tax cut of 1981.

Filing Your Tax Return Is Terrible -- But It Was Worse 100 Years Ago (http://www.forbes.com/sites/taxanalysts/2014/03/06/filing-your-tax-return-is-terrible-but-it-was-worse-100-years-ago/)
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If Piketty had his way, America would return to the tax rates of the early postwar era — he has repeatedly suggested that a top rate in the neighborhood of 80 percent would be reasonable and ultimately beneficial for most nations. I have my doubts about that — if you think aggressive and creative forms of tax avoidance are a problem now, just imagine what they'll be like when top rates double.

But Piketty is certainly right to underscore the social importance of taxing the rich. In America, we take tax consent for granted. In particular, we depend on a relatively high level of voluntary compliance. (God knows, we don't give the IRS enough resources to really enforce the income tax on its own.) This consent depends on some socially constructed and politically validated notion of fairness. And taxing the rich — adequately, if not extravagantly — is a vital part of that idea.

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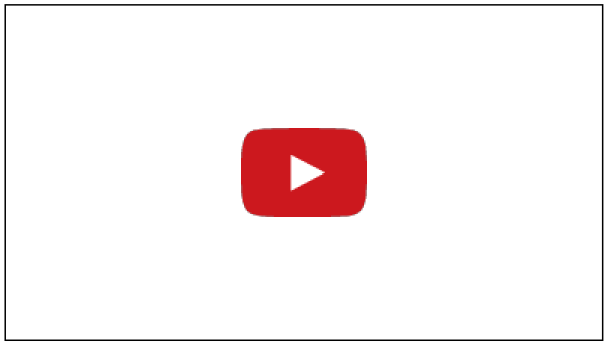


WEDNESDAY, JUNE 6, 2012

WHY WE HAVE TO RAISE TAXES ON THE RICH AND END THE BUSH TAX CUTS FOR THE WEALTHY (AND BILL CLINTON AGREES)

I was on CNBC Tuesday when Bill Clinton gave an interview saying that, given the deadlock between Republicans and Democrats on Capitol Hill, it seemed likely the Bush tax cuts would be extended in 2013 along with all spending. When asked to comment, I said Clinton was probably correct.

But, of course, Republicans have twisted Clinton's words into a pretzel. They say the former president came out in favor of extending the Bush tax cuts to the wealthy – in sharp contrast to President Obama's position that they should not be.

It's typical election-year politics, except for the fact that the Republican megaphone is larger this time around due to all the Super PAC and secret "social welfare" organization bribes, er, donations that are filling Republican coffers.

Here's the truth. America has a huge budget deficit hanging over our heads. If the rich don't pay their fair share, the rest of us have to pay higher taxes — or do without vital public services like Medicare, Medicaid, Pell grants, food stamps, child nutrition, federal aid to education, and more.

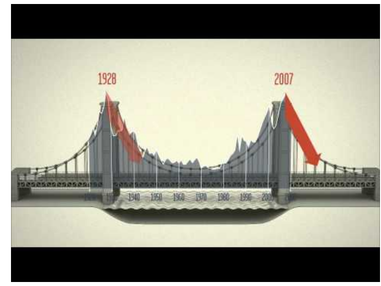
Republicans say we shouldn't raise taxes on the rich when the economy is still in the dumps. This is a variation on their old discredited trickle-down economic theories. The fact is, the rich already spend as much as they're going to spend. Raising their taxes a bit won't deter them from buying, and therefore won't hurt the economy.

In reality, Romney and the GOP are pushing an agenda that has nothing whatever to do with reducing the budget deficit. If they were serious about deficit reduction they wouldn't demand tax cuts for the very wealthy.

We should have learned by now. The Bush tax cuts of 2001 and 2003 were supposed to be temporary. Even so, they blew a huge hole in the budget deficit.

Millionaires received a tax cut that's averaged $123,000 a year, while the median-wage worker's tax cut has amounted to no more than a few hundreds dollars a year.

Bush promised the tax cuts would more than pay for themselves



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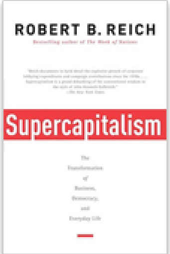
The 3 Biggest Myths Blinding Us to the Economic Truth

1. *The "job creators" are CEOs, corporations, and the rich, whose taxes must be low in order to induce them to create more jobs.* Rubbish. The real job creators are the vast middle class and the poor, whose spending induces businesses to create jobs. Which is why raising the minimum wage, extending overtime protection, enlarging the Earned Income Tax Credit, and reducing middle-class taxes are all necessary.

2. *The critical choice is between the "free market" or "government."* Baloney. The free market doesn't exist in nature. It's created and enforced by government. And all the ongoing decisions about how it's organized – what gets patent protection and for how long (the human genome?), who can declare bankruptcy (corporations?



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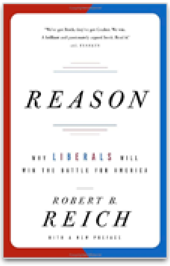

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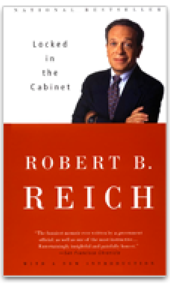

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in terms of their alleged positive impact on the economy. The record shows they didn't. Job growth after the Bush tax cuts was a fraction of the growth under Bill Clinton – even before the economy crashed in late 2008. And the median wage dropped, adjusted for inflation.

Let's be clear. Romney and the Republicans are pushing a reverse-Robin Hood plan that takes from the middle class and the poor while rewarding the rich.

According to the nonpartisan Tax Policy Center, Romney's tax plan would boost the incomes of people earning more than $1 million a year by an average of $295,874 annually.

Meanwhile, according to the Center on Budget and Policy Priorities, Romney's plan would throw ten million low-income people off the benefits rolls for food stamps or cut benefits by thousands of dollars a year, or both. "These cuts would primarily affect very low-income families with children, seniors and people with disabilities," the Center concludes.

The rich have to pay their fair share. Period.

Take a look at this video, in which I provide the three key reasons. (And pass it on.)

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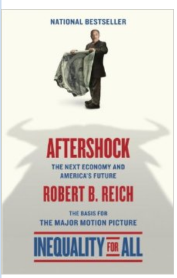
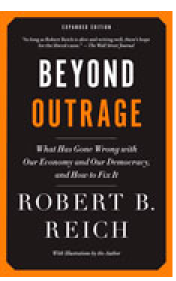




The Four Biggest Right-Wing Lies About Inequality

MONDAY, MAY 5, 2014

Even though French economist Thomas Piketty has made an air-tight case that we're heading toward levels of inequality not seen since the days of the nineteenth-century robber barons, right-wing conservatives haven't stopped lying about what's happening and what to do about it.

Herewith, the four biggest right-wing lies about inequality, followed by the truth.

Lie number one: The rich and CEOs are America's job creators. So we dare not tax them.

The truth is the middle class and poor are the job-creators through their purchases of goods and services. If they don't have enough purchasing power because they're not paid enough, companies won't create more jobs and economy won't grow.

We've endured the most anemic recovery on record because most Americans don't have enough money to get the economy out of first gear. The economy is barely growing and real wages continue to drop.

We keep having false dawns. An average of 200,000 jobs were created in the United States over the last three months, but huge numbers of Americans continue to drop out of the labor force.

Lie number two: People are paid what they're worth in the market. So we shouldn't tamper with pay.

The facts contradict this. CEOs who got 30 times the pay of typical workers forty years ago now get 300 times their pay not because they've done such a great job but because they control their compensation committees and their stock options have ballooned.

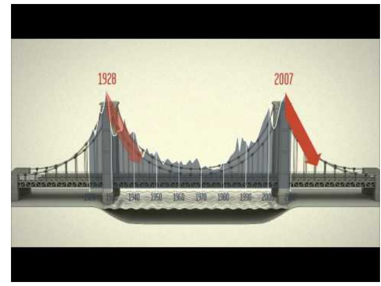
Meanwhile, most American workers earn less today than they did forty years ago, adjusted for inflation, not because they're working less hard now but because they don't have strong unions bargaining for them.

More than a third of all workers in the private sector were unionized forty years ago; now, fewer than 7 percent belong to a union.

Lie number three: Anyone can make it in America with enough guts, gumption, and intelligence. So we don't need to do anything for poor and lower-middle class kids.

The truth is we do less than nothing for poor and lower-middle class kids. Their schools don't have enough teachers or staff, their textbooks are outdated, they lack science labs, their school buildings are falling apart.

We're the only rich nation to spend less educating poor kids than we do educating kids from wealthy families.



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2. *The critical choice is between the "free market" or "government."* Baloney. The free market doesn't exist in nature. It's created and enforced by government. And all the ongoing decisions about how it's organized – what gets patent protection and for how long (the human genome?), who can declare bankruptcy (corporations?

All told, 42 percent of children born to poor families will still be in poverty as adults – a higher percent than in any other advanced nation.

Lie number four: Increasing the minimum wage will result in fewer jobs. So we shouldn't raise it.

In fact, studies show that increases in the minimum wage put more money in the pockets of people who will spend it – resulting in more jobs, and counteracting any negative employment effects of an increase in the minimum.

Three of my colleagues here at the University of California at Berkeley — Arindrajit Dube, T. William Lester, and Michael Reich – have compared adjacent counties and communities across the United States, some with higher minimum wages than others but similar in every other way.

They found no loss of jobs in those with the higher minimums.

The truth is, America's lurch toward widening inequality can be reversed. But doing so will require bold political steps.

At the least, the rich must pay higher taxes in order to pay for better-quality education for kids from poor and middle-class families. Labor unions must be strengthened, especially in lower-wage occupations, in order to give workers the bargaining power they need to get better pay. And the minimum wage must be raised.

Don't listen to the right-wing lies about inequality. Know the truth, and act on it.

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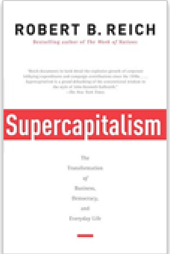

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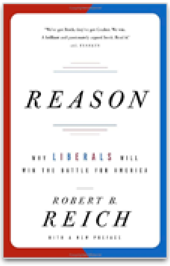

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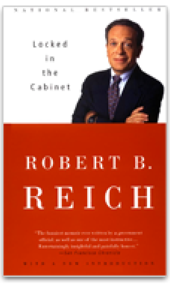

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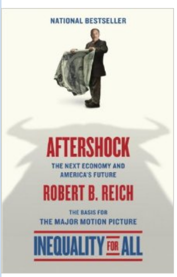

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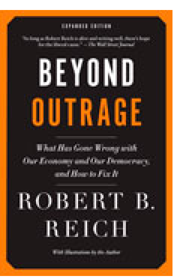

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The Three Biggest Lies about Why Corporate Taxes Should Be Lowered

MONDAY, AUGUST 5, 2013

Instead of spending August on the beach, corporate lobbyists are readying arguments for when Congress returns in September about why corporate taxes should be lowered.

But they're lies. You need to know why so you can spread the truth.

Lie #1: U.S. corporate tax rates are higher than the tax rates of other big economies. Wrong. After deductions and tax credits, the average corporate tax rate in the U.S. is lower. According to the Congressional Research Service, the United States has an effective corporate tax rate of 27.1%, compared to an average of 27.7% in the other large economies of the world.

Lie #2: U.S. corporations need lower taxes in order to make investments in new jobs. Wrong again. Corporations are sitting on almost $2 trillion of cash they don't know what to do with. The 1000 largest U.S. corporations alone are hoarding almost $1 trillion.

Rather than investing in expansion, they're buying back their own stocks or raising dividends. They have no economic incentive to expand unless or until consumers want to buy more, but consumer spending is pinched because the middle class keeps shrinking and the median wage, adjusted for inflation, keeps dropping.

Lie #3: U.S. corporations need a tax break in order to be globally competitive. Baloney. The "competitiveness" of American corporations is becoming a meaningless term because most big U.S. corporations are no longer American companies at all. The biggest have been creating way more jobs abroad than in the U.S.

A growing percent of their customers are outside the U.S. Their investors are global. They do their R&D all over the world. And they park their profits wherever taxes are lowest — another reason they pay so little in taxes. (Don't be fooled that a "tax amnesty" that will bring all that money back to America and generate lots of new investments and jobs here — see item #2 above).

Corporations want corporate tax reduction to be the centerpiece of "tax reform" come the fall. The President has already signaled a willingness to sign on in return for more infrastructure investment. But the arguments for corporate tax reduction are specious.

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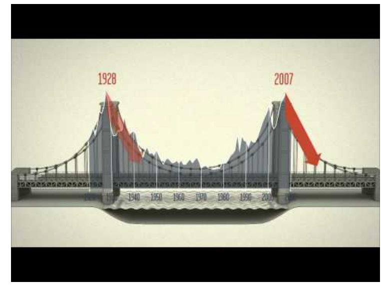

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The 3 Biggest Myths Blinding Us to the Economic Truth

1. *The "job creators" are CEOs, corporations, and the rich, whose taxes must be low in order to induce them to create more jobs.* Rubbish. The real job creators are the vast middle class and the poor, whose spending induces businesses to create jobs. Which is why raising the minimum wage, extending overtime protection, enlarging the Earned Income Tax Credit, and reducing middle-class taxes are all necessary.

2. *The critical choice is between the "free market" or "government."* Baloney. The free market doesn't exist in nature. It's created and enforced by government. And all the ongoing decisions about how it's organized – what gets patent protection and for how long (the human genome?), who can declare bankruptcy (corporations?

ISSUE BRIEF

May 15, 2013

BROADENING THE TAX BASE AND RAISING TOP RATES ARE COMPLEMENTS, NOT SUBSTITUTES

1986-style tax reform is a flawed template

BY ANDREW FIELDHOUSE

The Tax Reform Act of 1986, with its basic structure of "broadening the tax base and lowering rates," has become the lodestar for bipartisan tax reform. The *Moment of Truth* report by National Commission on Fiscal Responsibility and Reform Co-Chairs Erskine Bowles and Alan Simpson, the report of the Bipartisan Policy Center's Debt Reduction Task Force led by Alice Rivlin and Pete Domenici, and the U.S. Senate "Gang of Six" budget blueprint have all proposed variations of the "broadening the tax base and lowering rates" reform framework.

But it's time to move past 1986. Economic research and trends over the past quarter-century make clear that the "broaden the base and lower rates" blueprint is flawed. The right mantra should be "broaden the base and raise top rates." More precisely, policymakers should broaden the base by repealing tax preferences for capital income and—instead of raising the current 39.6 percent top statutory income tax rate—*add* higher tax rates for higher taxable-income thresholds to better match the skewed distribution of income.

This paper expands on Fieldhouse (2013), which reviews major findings from the public finance economic literature and their policy implications, to illuminate salient findings for upcoming debates regarding tax reform. Its main findings show why adding new higher top tax rates and broadening the base are complementary activities that would increase tax revenues and restore progressivity (needed to counter growing after-tax income inequality) all without hurting economic growth:

- Enthusiasm for lowering marginal tax rates is based partly on the false idea that lower marginal tax rates are a powerful spur to economic growth. Recent research on behavioral responses to taxation, as well as historical and cross-country regression analyses of top tax rates and macroeconomic performance, strongly suggest that these growth effects are substantially overstated.
- Also contrary to a popular myth, raising current top tax rates on high-income households would not sharply reduce productive economic activity. While tax increases do decrease upper-income households' reported taxable income more than they decrease moderate-income households' reported income, it is not because upper-income households choose to work less, but because they take advantage of their greater capacity to shift income from one category to another or one time period to another to reduce their taxes. Thus raising tax rates while broadening the tax base (by eliminating or curbing tax expenditures such as deductions, exclusions, credits, exemptions, and preferential treatment of capital income over labor income) and improving tax enforcement to minimize this avoidance thus could deter inefficient allocations of capital that are made simply for tax purposes.
- There is a revenue-maximizing tax rate (i.e., the tax rate associated with top of the Laffer curve), which is estimated as a function of behavioral responses to top tax rates. The U.S. top statutory federal income tax rate of 39.6 percent is still well below that "revenue-maximizing" rate based on best estimates of behavioral responses to the existing tax structure, by roughly 26 percentage points, according to some estimates.
- Tax reform that broadens the tax base and minimizes tax-avoidance opportunities would actually further *increase* that revenue-maximizing top statutory federal income tax rate, by as much as an additional 10 percentage points. Simply put, high-income households would have less ability to avoid taxes by shifting the form or timing of their compensation, and this would decrease their overall behavioral response of reported income to top tax rates.
- In the current top tax bracket, roughly the top 1.0 percent of households, income has become increasingly skewed toward the top. Therefore, rather than raising the top tax rate on married joint-filers making just above the $450,000 threshold, new tax brackets should be created; for example, a 45 percent tax bracket for joint-filers with taxable income above $2 million and a 50 percent tax bracket for joint-filers with taxable income above $10 million.
- One of the best base-broadening policies would be to end the preferential tax treatment of capital gains, which are now taxed at a top statutory rate of 20 percent, well below the 39.6 percent top statutory rate on ordinary income for taxpayers in the top tax bracket. Many highly compensated workers have the ability to reclassify labor income as capital income, and avoid taxes by shifting the timing of realizing income for tax purposes; they also access tax shelters that inefficiently reallocate capital from more productive uses. Base-broadening should therefore include reducing the gap between tax rates levied on wage income versus capital gains and other sources of investment income.

- In addition to tackling the preferential capital gains tax *rate*, policymakers should consider repealing two preferences that increase avenues for tax-avoidance and amplify the overall behavioral response of capital gains realizations with respect to capital gains tax rates: the "step-up basis of capital gains at death" (which allows for taxes to be avoided on inherited capital assets, particularly stocks) and the "carryover basis of capital gains on gifts" (which allows for taxes to be avoided on capital assets given as gifts). Repealing these preferences would decrease efficiency losses from capital gains taxation and increase the revenue-maximizing capital gains tax rate.

The fallacy of broadening the tax base and lowering tax rates

Broadening the tax base simply means subjecting more gross income to taxation by eliminating or curbing tax expenditures such as deductions, exclusions, credits, exemptions, and preferential treatment of capital income over labor income. Such reforms have value beyond raising revenue; they would help the tax code adhere more closely to the principle of horizontal equity, a core public finance and taxation theory concept stating that two people with the same income should not pay significantly different effective tax rates based on the ability to exploit tax code preferences or loopholes.[1] As explained below, these base-broadening reforms should be complemented by *higher* top rates—not *lower* top rates, as was the case in the 1986 tax reforms—in order to restore lost tax progressivity and ensure revenue adequacy for the future.

Why the 1986 tax reforms are a poor template

The Tax Reform Act of 1986 broadened the tax base, most notably by repealing the preferential treatment of capital gains, and lowered the top individual income tax rate from 50 percent to 28 percent.[2] Policymakers intended the 1986 model to be both revenue neutral and distributionally neutral (Shaviro 2011), meaning that effective tax rates would remain roughly unchanged across incomes.[3] This mandate for revenue and distribution neutrality was also later incorporated in the recommendations made by President George W. Bush's Advisory Panel on Federal Tax Reform, although the Bush-era tax cuts themselves violated this spirit by lowering overall effective tax rates, disproportionately so for high earners (Fieldhouse and Pollack 2011).[4]

Targeting these objectives today would imprudently disregard economic and budgetary shifts over the past quarter century. The Bush-era tax cuts significantly shrank projected future budget surpluses—helping turn them to structural budget deficits—and left revenue short of what is needed to fund the projected rapid growth of federal health programs in coming decades. (This outlook is essentially unchanged by the lame-duck budget deal.) Meanwhile, rising income inequality—exacerbated by reductions in top tax rates (Hungerford 2011; Hungerford 2012)—has surpassed Gilded Age levels, and will continue to be exacerbated for some time by the sustained, depressed demand for labor and ongoing jobs crisis (Bivens, Fieldhouse, and Shierholz 2013).

Furthermore, to the degree that many tax expenditures are most accurately viewed as government spending programs administered through the tax code (Marron and Toder 2012), New York University School of Law professor Daniel Shaviro rightly notes that "a revenue neutrality norm in which the budgetary gain from their repeal ostensibly needs to be offset by rate cuts is intellectually incoherent" (Shaviro 2011).

Despite the fact that revenue neutrality and distributional neutrality are clearly inappropriate goals for tax reform today, the 1986 reforms are viewed as a template largely because they succeeded politically, passing a divided Congress and enacted by a lame-duck president. Similarly, comprehensive reform today would have to overcome major political hurdles, particularly Republican intransigence over raising revenue.

But there is an additional economic dimension that drives enthusiasm for the "broadening the tax base and lowering rates" formulation: Many believe that low marginal tax rates are a powerful spur to economic growth. However, recent research on behavioral responses to taxation, as well as historical and cross-country regression analyses with respect to top tax rates and macroeconomic performance, strongly suggest that these growth effects are substantially overstated (Fieldhouse 2013).

Moreover, cleaning the tax code of exemptions and credits and other tax expenditures will decrease efficiency losses from the *existing* structure of the income tax code by subjecting more gross income to higher tax rates both through mechanical channels (i.e., reduced revenue loss from tax expenditures, ignoring behavioral effects) and behavioral effects (i.e., reduced avoidance).

Behavioral responses of upper-income households indicate that broadening the tax base is complemented by higher marginal tax rates

The bottom-line parameter for assessing the economic effects and desirability of tax changes is the "elasticity of taxable income" (ETI), which is simply the change in reported taxable income (and hence revenue) that accompanies changes in marginal tax rates. The higher the ETI (in absolute-value terms), the more distortionary the changes in tax rates.[5] Simply put, if taxable income is very elastic with respect to tax changes, then small increases in marginal rates will cause large decreases in reported income. If this elasticity is greater than one, then raising tax rates will actually decrease total tax collections—the famous phenomenon of being on the wrong side of the "Laffer curve."[6]

Over the last half century, much policymaking toward top marginal tax rates took for granted that high-income households were very responsive to tax changes, and could well be close to the wrong side of the Laffer curve. New evidence demonstrates that this is not true. In a review of the literature, McClelland and Mok (2012) conclude, "There is little compelling evidence that high-income taxpayers have substantially higher elasticities with respect to their labor input than lower-income taxpayers."

Further, much of the *measured* responsiveness of high-income households to tax changes is not a function of them reducing productive economic activity (i.e., working less or saving less) in response to higher tax rates. Instead, this responsiveness largely reflects these households' ability to avoid taxation through income-shifting or income-timing (i.e., strategically reclassifying the form of income or timing the realization of income for tax purposes). As McClelland and Mok (2012) find, "Higher estimates of the elasticity of broad income among high-income taxpayers appear to reflect their greater ability to time their income rather than greater changes in their labor supply."

This key finding indicates that policymakers need not worry that potential economic output will be affected by upper-income households' predominant behavioral responses to changing top rates, as shifting the form or timing of their compensation has a negligible effect on long-run potential growth.

As evidence of this finding, upper-income households' *taxable* income (after deductions) is empirically more responsive to tax rate changes than their *broad* income (before deductions). Gruber and Saez (2002), for example, have found a higher 0.57 ETI *after deductions* and a lower 0.17 elasticity of broad income *before deductions*. This important finding implies that reported taxable income becomes less responsive to tax rate changes when the tax base is broader—i.e., when avoidance strategies are minimized through stricter tax enforcement and/or a cleaner tax code with fewer deductions, exemptions, and exclusions, as well as tax neutrality between capital and labor income.

This result also strongly indicates that tax reform that broadens the tax base is actually *complemented* by higher marginal tax rates, as the ETI is the principal economic parameter determining the revenue-maximizing tax rate (Saez, Slemrod, and Giertz 2012). That is, the broader the tax base, the lower the behavioral responses to taxation (the lower the ETI), and thus the higher the revenue-maximizing top tax rate. In current tax policy debates, however, raising top rates and broadening the base are generally treated as substitutes.

Research by Saez, Slemrod, and Giertz (2012) and Diamond and Saez (2011) suggest that top tax rates are currently well shy of revenue-maximizing levels, and that broadening the tax base and minimizing avoidance would even further increase the revenue-maximizing rate. Based on a preferred estimated ETI of 0.25, Diamond and Saez (2011) estimate the revenue-maximizing top income tax rate is 73 percent (combining federal, state, and local taxes). This implies that policymakers could raise the top statutory *federal* income tax rate to roughly 66 percent—more than 26 percentage points above the prevailing 39.6 percent rate (see Fieldhouse 2013 for details on these calculations).[7]

But Diamond and Saez (2011) also note that Gruber and Saez's (2002) pre- and post-deduction elasticities for the top of the income distribution, ranging from 0.17 to 0.57, imply a revenue-maximizing total top income tax rate of between 54 percent and 80 percent, depending on how narrow or broad the tax base is. This range of estimates would imply revenue-maximizing top federal income tax rates between 37 percent and 76 percent (Fieldhouse 2013).[8]

Again, the important takeaway from this range of estimates is that base-broadening (i.e., eliminating exclusions, deductions, credits, and preferences) *increases* the revenue-maximizing tax rate. This is to suggest that base-broadening tax reform is complemented by a higher top tax rate, but not necessarily by raising the current 39.6 percent top statutory income tax rate. That rate is applied to taxable income above $450,000 for married joint filers, a threshold that has been reduced precipitously from roughly $1 million in the early 1970s and roughly $3 million in the early 1950s (adjusted to 2012 dollars), as discussed in Fieldhouse (2013). The growth and distribution of income within the top 1.0 percent of households by income (those in the top tax bracket, roughly speaking) is also quite skewed; better policy would *add* higher tax rates to better match the skewed distribution of income. For instance, EPI's most recent progressive budget blueprint proposed adding a 45 percent income tax rate above $2 million in taxable income and a 50 percent income tax rate above $10 million in taxable income, both for joint filers (Bivens et al. 2012).

Conversely, base-broadening tax reform is all too often focused on *reducing* top marginal tax rates already below best estimates of the revenue-maximizing rate.

The most important base-broadener: ending the preferential tax treatment of capital income

Much of upper-income households' greater ability to minimize tax liability stems from the capacity to time, shift, and shelter income afforded by the preferential treatment of capital income over labor income, particularly the preferential tax rates on capital gains. The equalization of tax rates on capital gains and ordinary income from the Tax Reform Act of 1986 has long been ended, and the Bush-era tax cuts created a new preferential rate on dividends (previously taxed as ordinary income). Indeed, the American Taxpayer Relief Act (ATRA) of 2013 (i.e., the lame-duck budget deal) made permanent preferential 20-percent top statutory rates on both long-term capital gains and qualified dividends for taxpayers in the top 39.6 percent tax bracket.[9] Thus, for upper-income households, capital income is taxed at substantially lower rates than ordinary income.

Capital income is heavily concentrated at the top of the income distribution, with roughly 75 percent of the benefit of the preferential rates on long-term capital gains and qualified dividends accruing to the top 1.0 percent of households ranked by income (Toder and Baneman 2012).[10] Economist and tax policy expert Leonard Burman (2011) concluded in testimony before the Senate Finance Committee that "the biggest loophole is the lower tax rate on capital gains," adding later that "lower capital gains tax rates fuel inefficient tax shelters that entail a significant economic cost" (2011).

Many highly compensated workers have the ability to reclassify labor income as capital income, famously in some cases through "carried interests" in partnership profits (the "carried interest" loophole). This loophole allows much of the compensation of some financial-fund managers to be taxed at the preferential capital gains rate, as opposed to the higher ordinary income tax rate, and thus additionally avoiding uncapped Medicare payroll taxes on wages and salaries. Other capital income preferences, notably the tax exclusion for interest on municipal bonds, allow households to shift income or wealth into assets whose returns are excluded from taxable income.

Further, unlike dividends payments subject to annual taxation when disbursed, tax filers have discretion in determining when to realize capital gains (or losses) and subject them to taxation (or deduct losses). Capital gains taxes are assessed on the difference between the sale price and the purchase price of an asset, which is known as the basis for capital gains. For assets that are bequeathed, the basis price for heirs is reset to the value at the time of transfer rather than at the time of purchase (this is known as the "step-up basis of capital gains at death"). In other words, families can avoid capital gains taxation altogether by never realizing capital gains until shortly after assets are bequeathed, thereby minimizing intergenerational tax liability. For example, if an heir inherits a stock portfolio valued at $1 million, she could immediately liquidate it to pay zero income tax (assuming there has been no subsequent appreciation or depreciation). Sufficiently large bequests would be subject to some estate tax liability (indeed, the step-up basis is intended to avoid double taxation of intergenerational transfers), but the estate tax has been deeply hollowed out over the past 12 years, and a historically high exemption and low top rate were made permanent by ATRA. The step-up basis of capital gains would be repealed statutorily if the estate tax were repealed (TPC 2013), and, interestingly, would on net likely generate substantial revenue because projected estate tax receipts have fallen so sharply.[11]

The tax code also enables households to avoid paying taxes on capital gains accruals by allowing them to transfer the donor's basis valuation to a donee along with appreciated assets given as gifts—the "carryover basis of capital gains on gifts." Many recipients of such gifts are tax-exempt institutions, so these accruals will likely never be subject to any taxation.

In discussions with Economic Policy Institute staff about the revenue-maximizing capital gains tax rate, Leonard Burman noted that the capital gains realization elasticity is raised by the step-up basis of capital gains.[12] Essentially, the additional option this step-up basis affords taxpayers for intergenerational avoidance of capital gains taxes means they have another avenue through which to respond to higher capital gains tax rates. Consequently, repealing the step-up basis would *decrease* efficiency losses from standing capital gains taxation and push up the revenue-maximizing long-term capital gains tax rate. The carryover basis of capital gains on gifts almost certainly elevates the capital gains realization elasticity as well, although the elasticity, revenue, and progressivity implications are much more modest.[13]

More broadly, the preferential tax rate on capital gains opens a host of income sheltering and tax arbitrage opportunities. In testimony before the Senate Finance Committee, Burman (2012) noted that "the difference in tax rates between capital gains and other income is a prime factor behind individual income tax shelters," and that tax code arbitrage was distorting investment decisions away from more productive uses of capital.

Broadening the tax base by repealing the step-up basis of capital gains and the carryover basis of capital gains on gifts would make raising the capital gains tax rate more efficient and would also increase the revenue-maximizing tax rate. Improving tax neutrality between income forms by more closely harmonizing the tax rates on capital gains and wages and salaries—or better yet by repealing the capital gains and dividends preferences altogether—would in turn decrease the ETI with respect to marginal ordinary income tax rates.[14] Again the lesson is clear: Base-broadening (in this case minimizing the opportunity to exploit different tax rates applying to different legal classifications of income sources) increases revenue-maximizing top rates. Therefore, a broader base and higher rate should be seen as complementary, not substitutable.

The preferentially low 20 percent top statutory tax rate on qualified dividends has much less of a justification than the capital gains preference, notably because there are fewer avenues for tax avoidance behavioral responses since dividends are taxed annually as they are disbursed.[15] And prior to the 2003 Bush tax cuts, qualified dividends were taxed as ordinary income. In discussions with Economic Policy Institute staff about the revenue-maximizing capital gains tax rate, Tax Policy Center staff suggested that behavioral responses to the tax rate on qualified dividends are close to negligible.[16] From a corporate finance perspective, there is some merit in horizontally equitable tax treatment between capital gains and dividends to avoid distorting firm payout strategy, such as tilting the balance toward share repurchases (passed on to shareholders as capital gains) over dividends payments because of tax reasons. But there is also a strong revenue and equity argument for again taxing qualified dividends as ordinary income and simultaneously raising the capital gains rate—or better, repealing the capital gains preference entirely—which, by decreasing or eliminating this tax wedge, would mitigate concerns about tax arbitrage driving corporate payout strategies.

Conclusion

Put simply, if the aim of tax reform is to generate revenue and restore lost progressivity, *lowering* top income tax rates as the 1986 framework did would be a step in the wrong direction. And this is true even if reform leads to a broader base. Lowering top marginal rates on labor or capital income would decrease the progressivity of the tax-and-transfer system and likely exacerbate market-based income inequality growth (Fieldhouse 2013).

Short of reneging on the nation's commitments to ensuring health care for the elderly, poor, and disabled, Congress must raise substantially more revenue than projected under current policy. To do that, we don't need a repeat of 1986-style reform. Instead, we need a context-based overhaul that eliminates some of the more regressive tax preferences and decelerates income inequality growth. This overhaul should also heed lessons from recent public finance research and begin viewing a broader base as an opportunity to raise rates while decreasing efficiency losses.

And the greatest opportunities for base-broadening with respect to decreasing tax avoidance and income sheltering, as well as increasing progressivity, are the tax preferences for investment income, including the "carried interest" loophole, preferential rates on capital gains and qualified dividends, step-up basis of capital gains, and tax exclusion for municipal bond interest.

In short, we need tax reform that ensures revenue adequacy for the future, restores lost tax progressivity, and treats raising top marginal rates and broadening the tax base as complements rather than substitutes.

*— **Andrew Fieldhouse** is a federal budget policy analyst with the Economic Policy Institute and The Century Foundation. He previously worked as an assistant budget analyst and research assistant with the House Budget Committee. His areas of research and interest include federal tax and budget policy, political economy, public investment, and macroeco-*

nomics. Andrew has provided frequent commentary on the current budget debate and the impact of fiscal policy on the economic recovery.

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Endnotes

1. The corollary principle of vertical equity states that taxpayers with greater resources should pay a higher share of their income in taxes than those with fewer resources, or that effective tax rates should rise with income. As this paper discusses, tax preferences for capital income undermine both vertical and horizontal equity principles at the top of the income distribution.

2. The statutory preferential rate on long-term capital gains was 20 percent prior to reform, which repeal effectively raised to 28 percent.

3. Most of the base broadening in the Tax Reform Act of 1986 was actually on the corporate income side, although distributional analysis of tax changes typically assigns the incidence of corporate income tax changes to individual shareholders. On the individual income tax side, the biggest base-broadening reforms were repealing the preferential tax rate on capital gains and establishing limits on contributions to tax-preferred retirement plans, both of which were reversed in 1997 (Gravelle and Hungerford 2012). Most itemized deductions were left untouched, although the mortgage interest deduction was capped (at high levels), and deductions for sales taxes and consumer interest were repealed (Gravelle and Hungerford 2012).

4. The Bush-era tax cuts generally refer to the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 and Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, although there were a number of tax changes over 2001–2008. Subsequent tax changes primarily accelerated the implementation of provisions in the 2001 and 2003 tax cuts.

5. ETIs can be estimated with respect to any marginal tax rate, but much of the public finance literature is concerned with the ETI with respect to the net-of-top-marginal tax rate (i.e., 1-τ, where τ is the top marginal tax rate), the most policy-relevant variable for comprehensive tax reform and its revenue implications. Note that economic distortions from tax rate changes can influence both productive and unproductive economic activity.

6. More accurately, if the absolute value of the point elasticity of taxable income with respect to the marginal tax rate is equal to 1, then the top of the Laffer curve has been reached. If the absolute value of the point elasticity of taxable income with respect to the marginal tax rate is greater than 1, then top tax rates are *higher* than the revenue-maximizing rate—that is, the tax structure is "on the wrong side" of the Laffer curve. Note also that elasticities are dependent on both the starting marginal tax rate and tax avoidance opportunities afforded by tax enforcement and preferences.

7. Their preferred ETI estimate of 0.25 is based on best estimates of the long-run elasticity, ranging between 0.12 and 0.40, reported in Saez, Slemrod, and Giertz (2012).

8. While a small part of this range of estimates falls below the prevailing top tax rate, it is important to remember that both the 1) revenue-maximizing *federal* income tax rate given a revenue-maximizing *total* income tax rate and 2) revenue-maximizing *total* income tax rate given a specified elasticity are nonlinear relationships, and their preferred estimate from the midpoint elasticity of 0.25 is strong evidence that the revenue-maximizing top tax rate is on the high end of this range. See Fieldhouse (2013) for calculations of the revenue-maximizing top federal income tax rate from this range of top total income tax rates.

9. As a result of the Affordable Care Act, investment income for households with adjusted gross income above $200,000 ($250,000 for joint filers) is additionally subject to a 3.8 percent Medicare Hospital Insurance surcharge as of January 1, 2013.

10. This compares with 26.4 percent of the benefit of itemized deductions, 15.9 percent of the benefit of exclusions, 8.3 percent of the benefit of above-the-line deductions, and 8.3 percent of the benefit of nonrefundable tax credits, all for the top 1.0 percent of households by income (Toder and Baneman 2012).

11. EGTRRA repealed the estate tax for 2010, and in that year replaced the step-up basis of capital gains at death with a modified carryover basis for capital gains bequests. The estate tax and step-up basis of capital gains were reinstated in 2011. The Office of Management and Budget (OMB) Federal Receipts Analytical Perspective from the president's fiscal 2014 budget request estimated that the step-up basis of capital gains would result in $149.8 billion of revenue loss over fiscal 2014–2018. Extrapolating from this score for economic growth, we estimate that repealing the step-up basis would save $337.7 billion over fiscal 2014–2023. Conversely, the Congressional Budget Office projects that only $197.6 billion will be collected from estate and gift taxes over fiscal 2014–2023 (CBO 2013). The Bush-era tax cuts gradually hollowed out the estate tax from an exemption of $675,000 ($1.35 million for married couples) and top rate of 55 percent in 2001 to an exemption of $3.5 million ($7 million for married couples) and top rate of 45 percent, before repealing the tax entirely for 2010. The estate tax was reintroduced for 2011 and 2012 at an inflation-indexed exemption of $5 million ($10 million for married couples) and top tax rate of 35 percent—the least progressive structure of the most progressive federal tax since the 1930s. ATRA permanently set an inflation-indexed exemption of $5 million ($10 million for married couples) and top tax rate of 40 percent, at a cost of $369.1 billion relative to current law (JCT 2013).

12. This conversation was regarding elasticity assumptions in the Urban-Brookings Tax Policy Center's microsimulation tax model, but it was suggested that the same would hold true of elasticity estimates used by other official scorekeepers, notably the Joint Committee on Taxation. For more on capital gains realization elasticities and revenue modeling, see Gravelle (2010).

13. The OMB Federal Receipts Analytical Perspective from the president's fiscal 2013 budget request estimated that the step-up basis of capital gains would result in $149.8 billion of revenue loss over fiscal 2014–2018, roughly six times the $24.5 billion cost of the carryover basis of capital gains on gifts (OMB 2013).

14. Saez, Slemrod, and Giertz (2012) note that raising the top income tax rate while holding the top capital gains rate fixed at lower levels could increase the ETI with respect to marginal ordinary income tax rates (as increased tax arbitrage incentives fueled greater tax avoidance). See footnote 70 in Saez, Slemrod, and Giertz (2012).

15. See endnote 9.

16. See endnote 12.

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