

# Income Tax Reform and Inequality

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# 1. INTRODUCTION

## Two Facts

Income inequality and Income Concentration have increased substantially since 1970

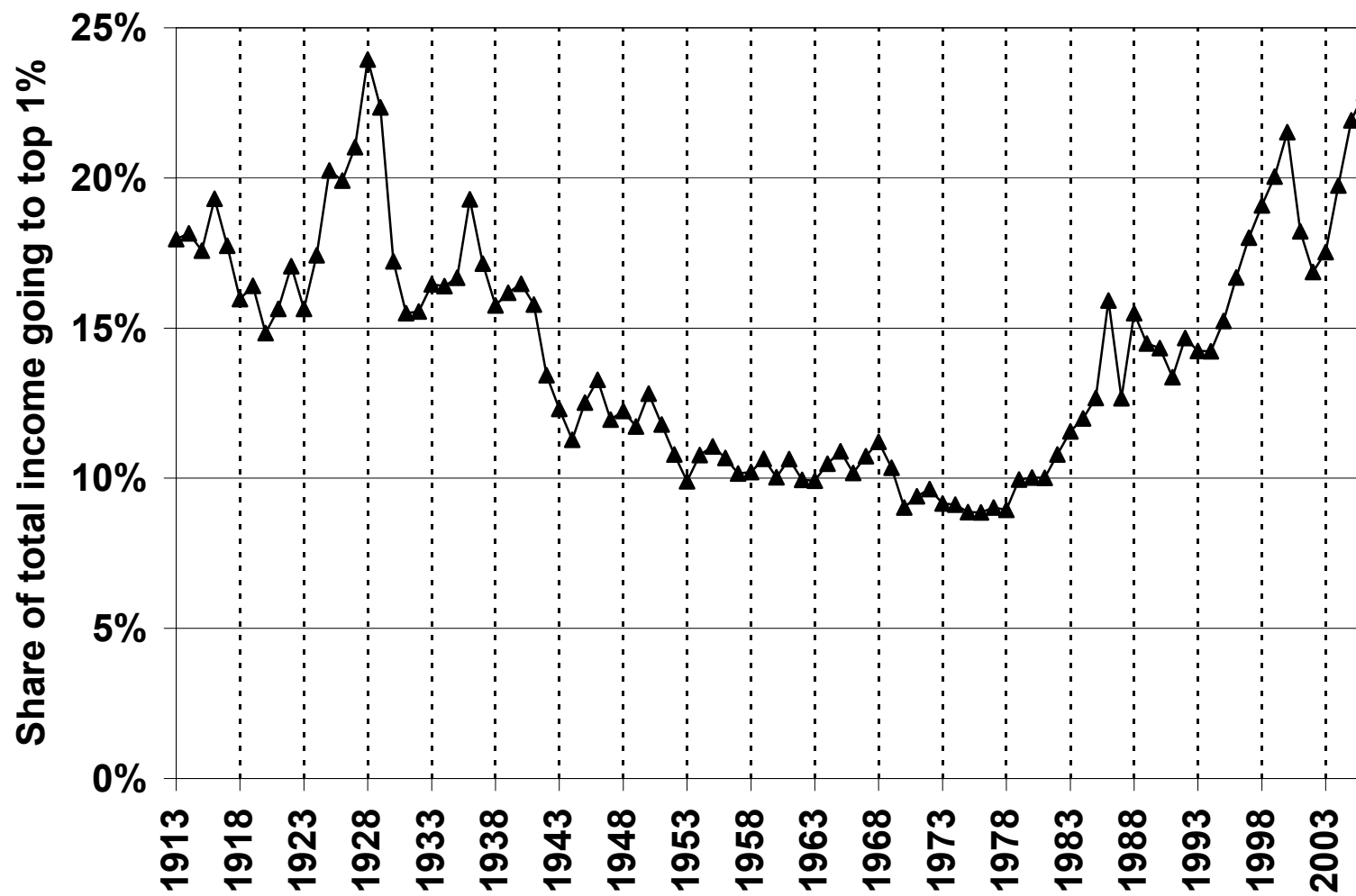
Progressivity of Federal Taxes (Income + Estate) has declined at the top but federal tax credits have increased at the bottom

## Two Questions

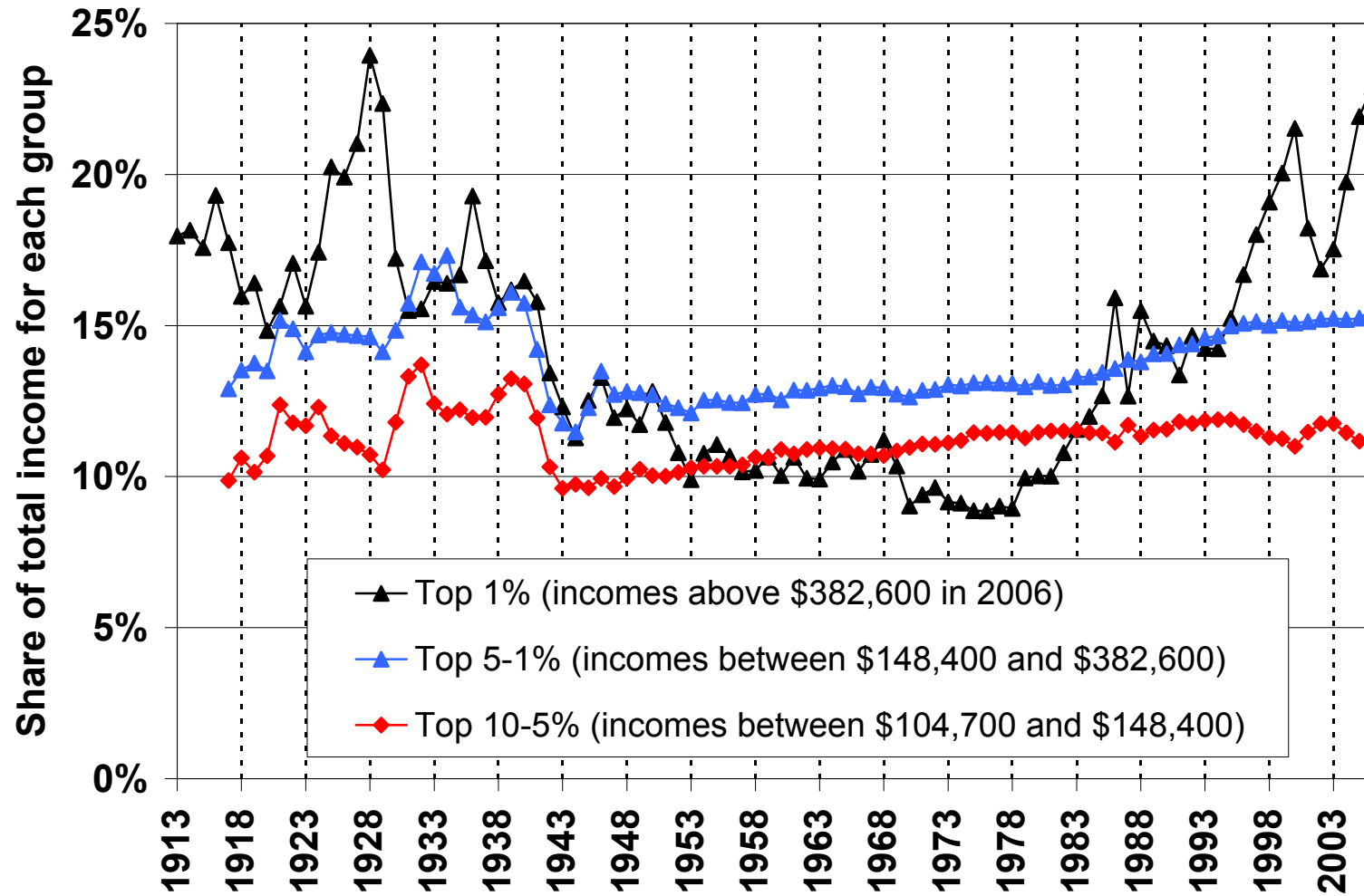
Should federal taxes be used more aggressively to mitigate the surge in income concentration?

Should federal income tax credits be expanded (and replace welfare programs) to alleviate poverty?

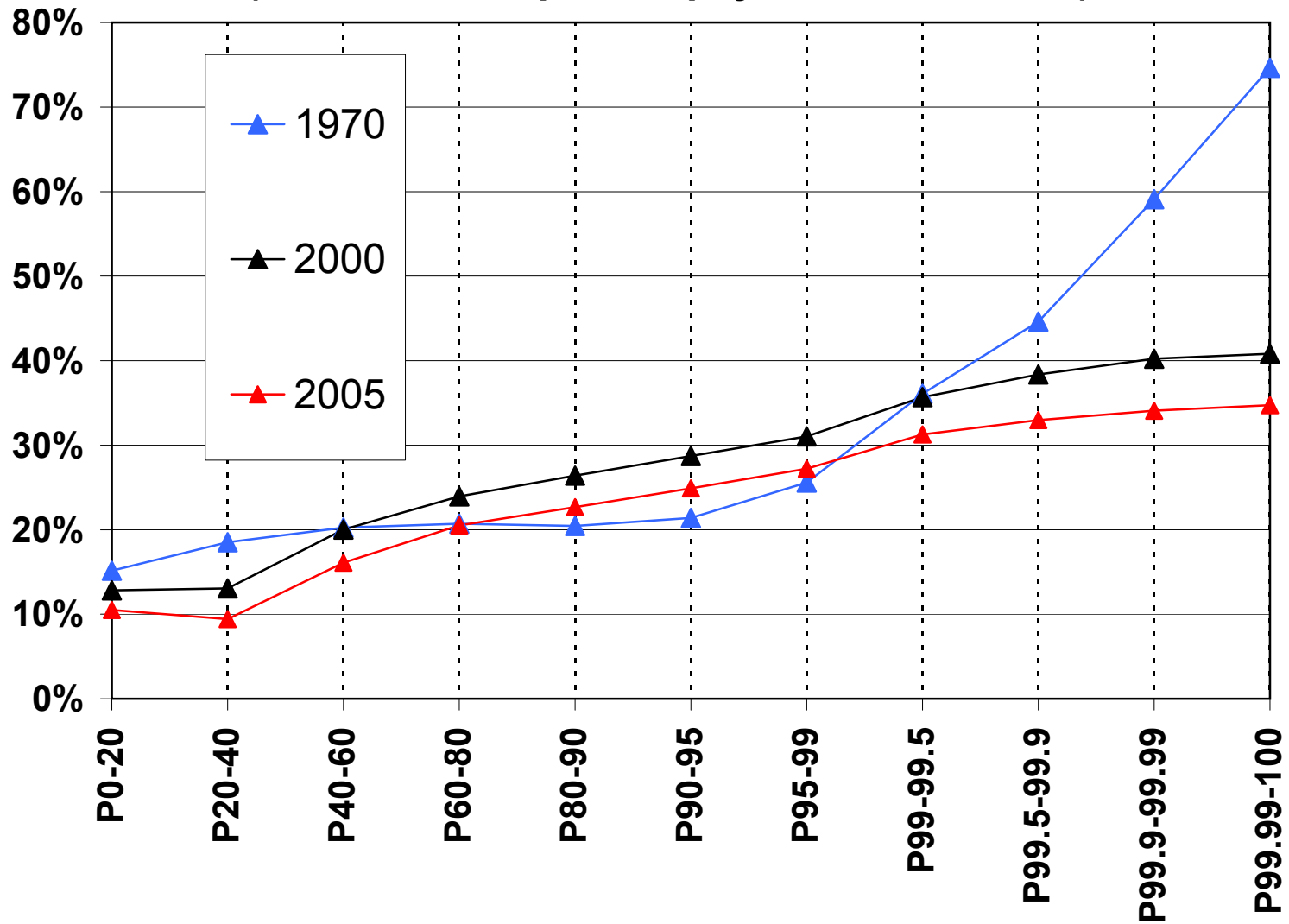
## Top 1% Income Share, 1913-2006



## Decomposing top 10% into 3 groups, 1913-2006



## 2. Federal Average Tax Rates by Income Groups (individual+corporate+payroll+estate taxes)



## **2. SHOULD TOP INCOME TAX RATES BE INCREASED?**

Yes, if this increases long-term total tax revenue

Economists try to evaluate how “behavioral responses” to tax changes affect reported income and ultimately tax revenue

Top tax rates cannot be too high if there are supply-side responses to tax changes

However, critical to distinguish various forms of behavioral responses

## 2. BEHAV. RESPONSES TO TOP TAX RATES

- **Real Economic Responses** (labor supply, savings, business creation, migration decisions): Critical but hardest to measure
- **Tax Avoidance Behavior** (shift income to tax favored forms, e.g., capital gains): (a) Change tax law to reduce scope for avoidance, (b) then increase tax rates
- **Compensation Excesses** (effort spent by executives at increasing their pay may depend negatively on top tax rates) ⇒ Higher top tax rates benefit shareholders and lower paid employees [could justify very high top tax rates]

## 2. PERSPECTIVES FOR REFORMING TOP TAX RATES

Income concentration will fall sharply during crisis but fall will be permanent only if tax progressivity increases substantially [contrast 1921 to 1932]

Politically, now might be the best moment to (a) close tax avoidance channels and (b) increase top tax rates [possibly going beyond Clinton tax system]

Income and Estate Tax reform needs to be framed as tax increase on the top 1% [top income earners engineered the bubble and subsequent crisis]

### 3. SHOULD INCOME TAX CREDITS REPLACE WELFARE TRANSFERS?

Refundable tax credits such as Earned Income Tax Credit and Child Tax Credit have become larger than Food Stamps and TANF. Obama administration proposes to expand those credits and add a payroll tax credit

- **Pros of Tax Credits:** Piggy-back on tax system (a) Lower admin costs for govt and recipients, (b) Less stigma and higher take-up for recipients
- **Cons of Tax Credits:** (a) Paid in one annual lump-sum (makes consumption smoothing costly), (b) Paid based on prior year income (recipients' circumstances may change quickly)

### **3. REFORMING INCOME TAX CREDITS**

Income tax credits should be “as-you-go” and automatic

Government could collect pay-stub information from employers in real-time [technologically feasible] and pay out monthly transfers based on earnings and family situation

Would make it much easier to administer other means-tested programs such as Medicaid (and future Universal Health Care expansions)

**Table 1. Real Annual Income Growth by Groups, 1993-2006**

	<b>Average Income Real Annual Growth</b>	<b>Top 1% Incomes Real Annual Growth</b>	<b>Bottom 99% Incomes Real Annual Growth</b>	<b>Fraction of total growth captured by top 1%</b>
	(1)	(2)	(3)	(4)
Full period 1993-2006	1.9%	5.7%	1.1%	54%
Clinton Expansion 1993-2000	3.7%	10.1%	2.4%	46%
Bush Expansion 2002-2006	2.8%	11.0%	0.9%	75%

Computations based on family market income including realized capital gains (before individual taxes).

Incomes are deflated using the official Consumer Price Index.

Column (4) reports the fraction of total real family income growth captured by the top 1%.

For example, from 2002 to 2006, average real family incomes grew by 2.8% annually but 75% of that growth accrued to the top 1% while only 25% of that growth accrued to the bottom 99% of US families.

Source: Piketty and Saez (2003), series updated to 2006