To Get the Top Rate to 28 Percent, Cut Investment Tax Breaks

By Marc Goldwein

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Many analysts claim there is a tax ''trilemma'' between revenue, progressivity, and economic growth that will make it difficult or impossible to substantially reduce tax rates without losing revenue or reducing progressivity. However, the inefficiencies of our code make it possible to overcome the tax trilemma if policymakers are willing to substantially pare back the trillion-plus dollars of tax preferences in the code — including those focused on investment income.

A recent study from the Tax Policy Center (TPC) throws cold water on former Massachusetts Gov. Mitt Romney's proposal to cut tax rates by 20 percent across the board while maintaining revenue and distributional neutrality.[1]

''Any revenue-neutral individual income tax change that incorporates the features Governor Romney has proposed,'' the TPC finds, ''would provide large tax cuts to high-income households, and increase the tax burdens on middle- and/or lower-income taxpayers.''[2]

Some analysts have been quick to jump on this study as proof that rate-reducing tax reform cannot be done in a fair and fiscally responsible way. They are wrong. The Bowles-Simpson commission, Domenici-Rivlin task force, and other prominent groups have shown it is possible to lower rates while increasing revenue and improving progressivity. But to do so, everything has to be on the table — especially investment preferences.[3]

The TPC shows that without addressing the special rules for capital gains, dividends, and various savings vehicles, it is impossible even to achieve revenue and distributional neutrality. Some have read this finding to suggest the plan TPC analyzes is too bold in its tax reductions. An equally valid explanation, however, is that the plan they looked at is not nearly bold enough in its tax expenditure cuts.

(Given political constraints, the reality may be a combination of the two — the plan the TPC analyzed would not only reduce all rates by 20 percent but also eliminate the alternative minimum tax, repeal the estate tax, eliminate the hospital insurance surtax from the Patient Protection and Affordable Care Act (PPACA), and eliminate most investment taxes on families making less than $200,000. While bold tax reform should be able to accomplish some of these goals, it may not be able to accomplish all of them.)

The apparent trade-off between the goals of increasing revenue, improving progressivity, and promoting economic growth is well known and sometimes referred to as the ''tax trilemma.''

The tax trilemma is theoretically sound when the starting point is a simplified and efficient tax code. Under such a system, achieving revenue and progressivity could come only from increasing top rates, which would reduce growth. Achieving progressivity and growth could come only from reducing bottom rates, which would reduce revenue. And achieving revenue and growth could come only from making the tax code flatter, which would reduce progressivity.

But that is true only in a perfectly efficient code. Our current tax code is littered with more than $1 trillion of tax expenditures — the various deductions, credits, exclusions, and other preferences that themselves are expensive, often regressive, and distortionary. Because most of these tax expenditures go to higher-income earners, eliminating them offers an opportunity to increase the progressivity of the tax code even while reducing rates, generating new revenue, and promoting economic growth.

Of course, the TPC study *does* consider this lower-the-rates, broaden-the-base approach. The study finds that even if a plan completely eliminated the mortgage interest deduction, charitable deduction, state and local tax deduction, employer-provided health insurance exclusion, and other major tax expenditures for the highest earners, the combination of reducing the top rate to 28 percent and other rates in kind, repealing the AMT and estate tax, and eliminating the upper-income surtax from the PPACA would overwhelm the base-broadening and result in a large tax cut for the wealthiest individuals.

What the study does not do is look at what might happen if tax reform also targeted some of the current tax preferences for savings and investment. Exempt from any scrutiny under the TPC's illustration are the preferential rates on capital gains and dividends, the exemption from paying any taxes on gains accrued before death, the exclusion of interest on state and local bonds, and the many retirement preferences in the current tax code.

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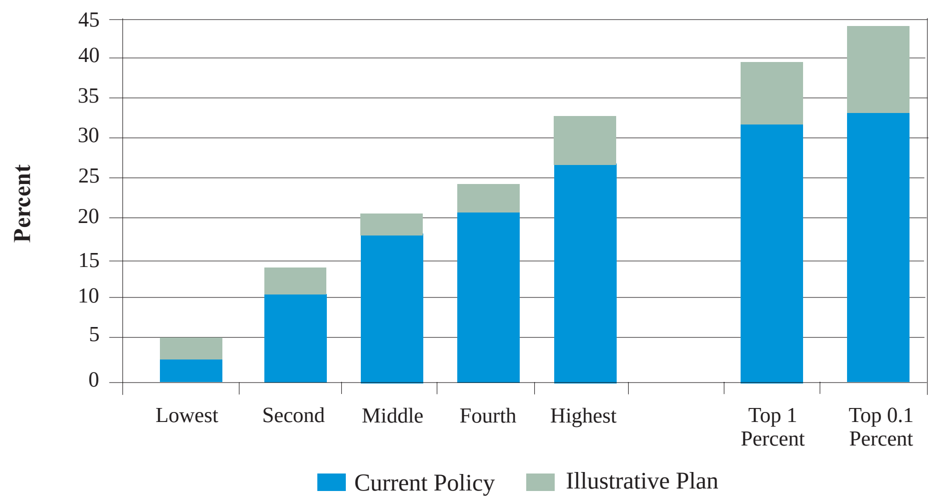
[1]*See Doc 2012-16395*, *2012 TNT 149-42*.

[2]*Id.*

[3]*See* the Bowles-Simpson report, *Doc 2010-25486*, *2010 TNT 231-35*, and the Domenici-Rivlin tax reform plan, *Doc 2011-22974*, *2011 TNT 212-39*.

Illustrative Example of Tax Trilemma				
	Simplified Tax Code	Increase Revenue And Progressivity	Increase Growth and Progressivity	Increase Revenue And Growth
Bottom rate	15%	15%	10%	20%
Middle rate	25%	25%	25%	25%
Top rate	35%	40%	35%	31%

Average Effective Tax Rates Under Current Policy and the Bowles-Simpson Illustrative Plan



Those preferences are skewed, to an incredible degree, to the very richest among us. In 2011, those in the top 0.1 (making more than $2.2 million that year) received an average tax benefit of more than $350,000 from the preferential rates on capital gains and dividends alone. By comparison, the average taxpayer received closer to a $25 benefit from these special rates.[4]

Addressing some of the tax preferences related to investment can greatly improve the progressivity of any reform plan. By taking on these measures, the Bowles-Simpson commission was able to suggest a plan that greatly increased the progressivity of the tax code even while eliminating the AMT and reducing the top rate to 28 percent.

Looking at tax year 2021, those in the bottom fifth of taxpayers would face a 0.7 percentage point increase in their effective rates under this plan, while those in the top fifth would see a 3.3-point increase in their effective rates and those in the top percentile would see their effective tax rate increase by 5.9 percentage points.

To be sure, the Bowles-Simpson commission does not cut the estate tax, the PPACA taxes, or some of the other rates as deeply as the plan the TPC analyzed, which explains some of the improvement in progressivity. But that isn't the whole story.

To achieve the necessary revenue, progressivity, and tax rate targets, the fiscal commission plan limited the size of retirement accounts, phased out the exclusion for interest on state and local bonds, eliminated step-up basis of capital gains at death, and taxed capital gains and dividends as they were after the 1986 tax reform — as ordinary income with a top rate of 28 percent. By making changes like these, it is fully possible to increase progressivity and revenue with a very low top marginal rate.

Of course, some might argue that by going after preferential treatment of savings and investment, tax reform would cease to be pro-growth even with the rate reductions.

Yet the empirical evidence of the link between capital gains rates and growth is weak at best. In one study, Troy Kravitz and Leonard Burman found that "capital gains rates display no contemporaneous correlation with real GDP growth during the last 50 years."[5] Studies by other economists — and even by the Congressional Research Service and Congressional Budget Office — have similar findings.[6]

[4] *Doc 2012-14520*, *2012 TNT 133-39*.

[5] Troy Kravitz and Leonard Burman, TPC, "Capital Gains Tax Rates, Stock Markets, and Growth," *Tax Notes*, Nov. 7, 2005, p. 815.

[6] Jared Bernstein, "More on Cap Gains and Investments," On the Economy blog (Jan. 20, 2012), *available at* http://jaredbern

(Footnote continued on next page.)

One explanation for this weak relationship is that the benefit of lower taxes on one type of capital income may be outweighed by the economic cost arbitrage and misallocation caused by the many different rates on capital income. Under current law, short-term capital gains, long-term capital gains, interest, dividends, corporate income, small business income, wage income, retirement account income, income from bonds, and appreciation of tangible assets are all taxed differently.

Lowering overall rates and then taxing all income the same could have substantial benefits by allowing businesses and individuals to make investment decisions based on what the market, not the government, thinks is best. Taxpayers would put more of their money into wise long-term investments and hand less to tax accountants and other intermediaries. These efficiencies by themselves are likely to make up for much or all of the potential losses from higher rates on capital gains.

And, in fact, the best way to encourage savings and investment is not through lower tax rates on specific types of investment, but through a comprehensive fiscal plan that reduces ''crowd-out'' of investment from excessive national debt and restores confidence in the future of the economy. For this reason, tax reform that brings in new revenue is not only consistent with economic growth, but perhaps necessary for it.

There is no question that policymakers could reduce the top rate substantially while not only maintaining revenue and progressivity, but increasing both. Such a tax reform will require bold thinking by policymakers — and tough choices to boot.

There may be political limitations that prevent these goals from ultimately being achieved. But done right, that reform can offer substantial improvement to economic growth, inequality, and our fiscal situation.

steinblog.com/more-on-cap-gains-and-investment/; Thomas L. Hungerford, ''The Economic Effects of Capital Gains Taxation,'' Congressional Research Service R40411 (June 18, 2010), *Doc 2010-14022*, *2010 TNT 122-17*; Statement of Leonard E. Burman Before the Senate Budget Committee, ''Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness'' (Mar. 1, 2012), *Doc 2012-4301*, *2012 TNT 42-35*; and CBO, ''Effects of Lower Capital Gains Taxes on Economic Growth'' (Aug. 1990), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/77xx/doc7767/90-cbo-033.pdf.