Policy Focus

Four Myths about American Taxes

RECIPES FOR RATIONAL GOVERNMENT FROM THE INDEPENDENT WOMEN'S FORUM

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WHAT YOU NEED TO KNOW

To paraphrase the late Israeli diplomat Abba Eban: When it comes to tax reform, U.S. lawmakers never miss an opportunity to miss an opportunity. Every time it appears that momentum is building for a sweeping overhaul of the kind we had in 1986, something derails the process. The latest casualty was the tax-reform plan introduced by House Ways and Means Committee chairman Dave Camp (R., Mich.), which was almost instantly declared "dead on arrival."

Why is tax reform so hard? There are many reasons, of course, but one big reason is the persistence of several myths about American taxes. For example, many people seem to believe that the United States (1) is a low-income-tax country, (2) has a relatively modest effective tax rate on corporate investment, (3) could raise a massive amount of new revenue by hiking the top federal rate on individual income, and (4) has a less progressive tax structure than most nations in Western Europe.

Each of those assertions is either deceptive or just plain wrong.

As this paper will demonstrate, America depends on income-tax revenue far more than most other developed countries; its marginal effective tax rate on corporate investment is among the very highest in the world; its federal tax on individual income has yielded a remarkably consistent amount of revenue over the past four decades, despite huge variations in the top rates; and its overall tax structure is actually more progressive than those of the major European welfare states.

WHY YOU SHOULD CARE

Everyone has an interest in making America's tax system more efficient, more reliable, and more competitive in the new global economy.

- **U.S. Income Taxes Impose Massive Compliance Costs…:** The Taxpayer Advocate Service estimates that, in 2010, people spent $168 billion just to comply with the federal government's individual- and corporate-income taxes, an amount equal to 15 percent of all income-tax receipts.
- **And Their Overall Economic Costs Are Even Larger:** In an age of globalization and mobile capital, high corporate-tax rates reduce investment in the United States, thereby preventing job creation, stifling wage growth, and making it harder for America to rebalance its economy away from consumption. Meanwhile, steep tax rates on individual income discourage work, entrepreneurship, and hiring, at a moment when America's labor-force-participation rate has fallen to levels not seen since the late 1970s.
- **Tax Myths Help Build Support for Misguided Policies:** By the same token, *refuting* tax myths can help make the case for the policy reforms America really needs, such as lowering the corporate rate and shifting the overall tax burden from income to consumption.

MORE INFORMATION

Myth #1: America Is a Low-Income-Tax Country

When economists compare the tax burdens of different countries, they typically divide total tax revenue by gross domestic product (GDP). In 2011, federal, state, and local governments in America collected tax revenue equal to 24 percent of GDP, whereas the average Organization for Economic Cooperation and Development (OECD) member collected 34.1 percent of GDP. So, in that sense, the United States can fairly be described as a "low-tax country," at least in comparison with other wealthy democracies.

But are we a low-*income*-tax country? That's more complicated, as Columbia law professor Michael Graetz (among others) has shown.

Perhaps the most notable difference between America's tax system and those of other OECD members is America's heavy dependence on income taxes rather than consumption taxes. In 2011, the United States collected less revenue from taxes on goods and services, as a share of GDP, than any other OECD nation. (The OECD average was 11 percent of GDP; America collected 4.4 percent of GDP.) Meanwhile, taxes on goods and services contributed just 18.3 percent of all U.S. tax revenue, well below the OECD average of 32.9 percent.

By contrast, taxes on income, profits, and capital gains accounted for 46.5 percent of all U.S. tax revenue, versus an OECD average of 33.5 percent. As a portion of GDP, the revenue generated by those taxes in America (11.2 percent of GDP) was very close to the OECD average (11.4 percent of GDP).

Tax Foundation analyst Kyle Pomerleau has calculated that, if we combine federal, state, and local taxes, America's average top marginal rate on capital-gains income is significantly *higher* than the weighted OECD average. In addition, the top marginal rate on wage income in states such as California, Hawaii, New York, Oregon, Minnesota, New Jersey, Vermont, and Maryland sits at European levels. On the other hand, the top tax rates in Europe generally kick in at lower income thresholds.

Here's the bottom line: America's excessive reliance on income-tax revenue has made our tax system woefully inefficient. Indeed, studies have determined that income taxes, especially corporate-income taxes, cause more damage to economic growth than consumption taxes. While there is no perfect way to gauge the size of a nation's income-tax burden, it's misleading (at best) to call the United States a low-income-tax country.

Myth #2: Tax Rates on U.S. Corporate Investment Are Relatively Modest

America stands out for its high statutory corporate-income-tax rate: At 39.1 percent—the combined total of the federal rate (35 percent) and the average state rate—it is now the steepest in the OECD. Still, one can easily find examples of prominent companies, such as Apple, Google, and General Electric, that have exploited loopholes to dramatically shrink their U.S. tax bill. Citing such firms, journalists and politicians have argued that America's *effective* tax rate on corporate investment is actually quite modest. A careful analysis suggests otherwise.

Economists Jack Mintz and Duanjie Chen of the University of Calgary explain that, when we're measuring a nation's effective corporate-tax burden, the key number is the *marginal* effective tax rate (METR) on corporate investment, which represents "the tax impact on capital investment as a portion of the cost of capital." Mintz and Chen estimate that, in 2013, America's aggregate METR on corporate investment was 35.3 percent, making it the OECD's highest. The weighted OECD average was 28.5 percent; countries with an METR below that level included the United Kingdom (25.9 percent), Germany (24.4 percent), Canada (18.6 percent), and Sweden (16.1 percent).

Mintz and Chen also observe that METRs on corporate investment in the United States vary considerably among different industries and firms. "With unequal tax burdens on business activities," they write, "the tax system distorts the allocation of capital in the U.S. economy with some businesses bearing more tax than others on capital investment."

It is thus not surprising that more and more U.S. companies choose to operate as "pass through" firms and have their profits taxed under the individual code instead of the corporate code. The Congressional Budget Office (CBO) reports that, between 1980 and 2007, the share of U.S. businesses structured as pass-through entities increased from 83 percent to 94 percent, and the portion of all business receipts collected by pass-through entities jumped from 14 percent to 38 percent.

As for U.S.-based multinationals that shift profits abroad, this phenomenon is not a sign that U.S. corporate taxes are too *low*, but a sign that they are too *high*. Slashing the statutory rate would encourage greater repatriation of overseas cash.

In reality, then, American corporations are not "undertaxed." Rather, they must navigate an unfair, uncompetitive tax system that discourages productive investment in the United States and rewards companies for keeping foreign profits in foreign lands. That's why corporate-tax reform should be a priority.

Myth #3: Higher Individual-Income-Tax Rates Would Deliver a Gusher of Revenue

Many lawmakers insist that raising the top *individual*-income-tax rates would guarantee a revenue surge. History tells a different story.

Over the past 40 years, the top federal rate on wage income has fluctuated significantly: It was 70 percent from 1974 to 1981, 50 percent from 1982 to 1986, 38.5 percent in 1987, 28 percent from 1988 to 1990, 31 percent in 1991 and 1992, 39.6 percent from 1993 to 2000, 39.1 percent in 2001, 38.6 percent in 2002, 35 percent from 2003 to 2012, and 39.6 percent in 2013. The top federal rate on long-term capital gains has swung back and forth, as well, from a high of 35 percent in the mid-1970s to a low of 15 percent in the mid-2000s, and then up to 23.8 percent in 2013.

That's a lot of variation. And yet, the amount of revenue generated by the individual-income tax as a portion of GDP has stayed remarkably consistent. Based on CBO data, the annual average was roughly 7.8 percent of GDP during the 2000s (i.e., from 2000 to 2009), 8.1 percent of GDP during the 1990s, 8.2 percent of GDP during the 1980s, and 8.1 percent of GDP from 1974 to 1981.

The biggest single-year amount (9.9 percent of GDP, in 2000) was a result of the Clinton-era tech bubble. The smallest single-year amount (6.1 percent of GDP, in 2010) was a consequence of the Great Recession. The total in 2007 (8.1 percent of GDP), when the top rate on wage income was 35 percent, was greater than the total in 1978 (7.9 percent of GDP), when the top rate was 70 percent.

In short: Simply hiking the top income-tax rate on the wealthiest Americans—even hiking it back to 70 percent (or higher), as certain liberal economists have proposed—would *not* guarantee a large revenue increase.

Myth #4:
Taxes Are More Progressive in Western Europe Than in America

At a time when income inequality has become a global cause célèbre, it is widely believed that America's tax system is less progressive than those of most Western European countries. But is that really true?

In fact, after surveying income, payroll, and property taxes between 1979 and 2004, Northwestern University sociologists Monica Prasad and Yingying Deng concluded that America actually had a *more* progressive tax structure than Australia, Belgium, Canada, Denmark, Finland, France, Germany, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom. When Prasad and Deng added sales taxes for the half-dozen nations offering adequate data, they found that America was "the *only* country to have an overall progressive tax structure" (emphasis added).

A separate study, by OECD researchers, measured the progressivity of household taxes (i.e., taxes on income and employee social-security contributions) in the mid-2000s, while adjusting for cross-country variations in income inequality. It determined that, among a group of 24 OECD members, the only nation with more progressive household taxes than the United States was Ireland, and *no* nation collected more revenue from its top 10 percent of earners, relative to their share of market income, than America. A subsequent OECD paper confirmed that "household taxes are more progressive in the United States than in most EU countries."

In other words, America boasts greater tax progressivity than most Western European nations even *before* we account for consumption taxes.

Although persistent, these four myths about U.S. taxes need to be rebutted so that we can move toward a system that reduces compliance burdens, encourages investment and economic growth, and treats all Americans fairly.

What the Top 1 Percent Earn, and What They Pay in Federal Taxes

In recent years, American politics has become fixated on "the 1 percent," a constantly changing group of the wealthiest earners. We always hear about their large income share; we hear much less about their federal-tax share.

The Congressional Budget Office reports that, in 2010, households comprising the top 1 percent of earners (based on pre-tax income) paid more than 24 percent of all federal taxes, including 39 percent of individual-income taxes. By comparison, the same group of households received 14.9 percent of before-tax income and 12.8 percent of after-tax income.

If we look at the top 5 percent of earners, they paid 41.4 percent of federal taxes, including 63.6 percent of individual-income taxes. As for their income share, they collected 27.4 percent of before-tax income and 24.3 percent of after-tax income.

These numbers further illustrate the progressivity of America's federal tax code.

WHAT YOU CAN DO

- **Get Informed:** To gain a better understanding of America's tax system, visit:
  - Independent Women's Forum
  - The Tax Foundation
  - The Tax Policy Center
- **Talk to Your Friends:** Help your friends and family understand these important issues. Tell them about what's going on and encourage them to join you in getting involved.
- **Become a Leader in the Community:** Get a group together each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.
- **Remain Engaged Politically:** Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

ABOUT THE INDEPENDENT WOMEN'S FORUM

The Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility.

IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.

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