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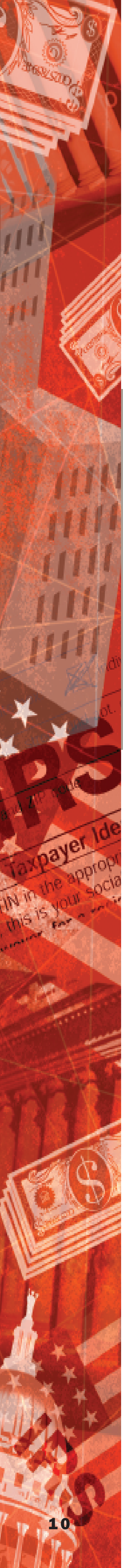

Tax Reform and Political Constituencies

The EITC and Child Credit give an advantage to low-income individuals with children compared to their childless counterparts, while Bush-era tax cuts benefit high-income individuals who earn their income from investments over those who earn salaries. The political landscape makes it unlikely that either of these inequities will be resolved anytime soon.

Because it's an election year, tax reform will receive a great deal of attention from the media and politicians. Yet even with the increased attention, little action is expected prior to the elections in November. The current structure of the tax system has effectively created two separate tax constituencies—one low-income constituency and one high-income constituency—that would clearly oppose a change in the benefits they receive from the tax system. Compounding the problem is that the two major political parties each appears to have embraced one of the constituencies and rejected the other. This makes it likely that the stalemate will continue. Those who don't fit into either of these groups will continue to be frustrated as both vertical and horizontal equity have been reduced and the basic fairness of the entire federal income tax (FIT) has been severely damaged.

Low-Income Constituency

Certain politicians make it a point of pride to note that they were part of ending "welfare" in our system. What they conveniently forget to mention is that a welfare-like system has effectively been rolled into the FIT. Two credits form the basis of the refundable credit system: the Earned Income Tax Credit (EITC) and the Child Credit (CC). (For a limited time, the American Opportunity Tax Credit works in a similar manner.)

Theoretically, the EITC operates to increase the minimum wage by encouraging individuals to work even when the employment carries low wages. Those with significant income of impermissible types ($3,200 in 2012) aren't eligible for the EITC, and the credit reaches its maximum benefits for individuals with children.

The CC is simply a $1,000 credit ($500 after 2012, if not extended) per qualifying child (under age 17) until the taxpayer reaches the income limit at which the credit begins to phase out. For a married couple filing jointly, the credit in 2012 doesn't begin phasing out until modified adjusted gross income (AGI) reaches $110,000. The credit is potentially refundable to the extent of 15% of the taxpayer's earned income over $3,000.

Let's look at an example that illustrates the disappearing horizontal equity in this constituency. Consider two taxpayers: One is single, and the other is married with two children. Each taxpayer earns identical incomes consisting solely of wages that result in an AGI of $44,050. Both take the standard deduction, and neither is eligible for any credits except for the EITC and CC. The married taxpayer files "married filing jointly."

Table 1 shows a summary of the Form 1040 calculations for tax year 2012. (Both taxpayers would pay employment taxes on the salary, so they aren't included in the example.) For the married individual with children, the combination of the wider 10% tax bracket and the greater standard deduction and exemptions leads to a tax disparity of more than $3,000 before credits, a much more favorable tax position. The refundable credits provide for an even greater disparity. While the single taxpayer owes almost $5,000 in taxes, the married taxpayer

Table 1. **Horizontal Inequity in the Low-Income Constituency**

	Single	Married + 2
AGI	$44,050	$44,050
Standard Deduction	(5,950)	(11,900)
Exemptions	(3,800)	(15,200)
Taxable Income	34,300	16,950
Tax Due before Credits	4,710	1,695
Child Credits	0	(2,000)
EITC	0	(655)
Net Tax Due (per rate schedule)	4,710	(960) refund

actually receives money back from the government. This is effectively a transfer (i.e., welfare) payment from the government.

High-Income Constituency

Rules promulgated under President George W. Bush have created a truly beneficial tax position for the high-income constituency if their income is derived from investment holdings. These rules have provided a long-term capital gains rate of 15% for high-income individuals along with a parallel rate for qualifying dividend income.

The rules provide that taxpayers who are in the 10% or 15% ordinary income brackets will receive a rate of 0% (effectively tax-free) on their long-term capital gains and qualifying dividends. Yet few taxpayers in those tax brackets have significant income from investments. Those who do are likely to be children or grandchildren of high-income individuals. If subject to the kiddie tax, these descendants will face the same rate their parents face. If they're old enough to avoid the kiddie tax, they can take advantage of the 0% rate.

The problem with this type of system is that it has the effect of destroying vertical equity. The problem is worsened because investment income isn't subject to employment taxes prior to 2013 and is subject to much lower rates after 2013.

Let's look at an example for tax year 2012 that demonstrates the lack of vertical equity between a high-income individual who earns income from salary-type items and an individual who earns income through investments and receives the benefit of the capital gains rates. Consider two single taxpayers. One is a successful CEO earning a salary and bonuses resulting in taxable income after all deductions of $500,000. The second individual is a descendent of a wealthy family and earns long-term capital gains and qualifying domestic dividends of $1 million. See Table 2 for their tax calculations.

Table 2. **Vertical Inequity in the High-Income Constituency**

	CFO	Investor
Taxable Income	$500,000	$1,000,000
Tax Calculation	$112,683.50 + 35% of all active income in excess of $388,350	0% on first $35,350, and 15% on balance of net long-term capital gains
Tax Due	$151,761	$144,698

In this example, the salary earner pays slightly more tax than the investor even though the investor has twice the income. In addition, this example understates the difference in taxes due to the impact of employment taxes on the salary earner.

Political Issues

In the debate over tax reform, the top marginal rate on ordinary income isn't the key issue. Among the ultra-rich (the top 0.1% of U.S. taxpayers), more than 60% of their income comes from long-term capital gains (*The Huffington Post*, "The Top 0.1% of the Nation Earn Half of All Capital Gains," www.huffingtonpost.com/2011/11/21/the-top-01-percent-capital-gains_n_1105055.html). The inclusion of qualifying dividends in long-term capital gains magnifies this.

Another key point is that federal welfare-like transfer payments haven't gone away; they have merely been hidden in the intricacies of the tax code. The

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policy issue is whether such a politically charged topic as welfare should be part of the basic revenue-generating mechanism of the federal government.

In the two simple examples we've looked at here, we've shown that tax reform has two major stumbling blocks—one at low-income levels and one at high-income levels. On the one hand, the Republicans want to make the Bush-era tax cuts permanent, embedding in the tax code the tax difference between wage income and investment income. On the other hand, the Democrats want to eliminate the Bush-era cuts for the top two tax brackets, increase the capital gains tax rate, and increase the EITC. As a result, neither party has any real incentive to move tax reform forward. **SF**

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