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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- The top income tax rate has been reduced to 35% while the top capital gains rate has been reduced to 15%
- For every $1 spent on a Texas lottery ticket, the buyer wins only $0.58. The odds are far worse than any casino game of chance.

Were the Recent Tax Cuts "Fair"?

In this political season, both major candidates have been making strident claims about the effect of the tax reforms passed by congress in 2001 and 2003. On June 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act (**EGTRRA**) of 2001. In addition to several pension reforms, EGTRRA reduced marginal income tax rates by 1% moving from 2001 to 2002. In May 2003, congress passed the Jobs and Growth Tax Relief Reconciliation Act (**JGTRRA**) of 2003.

This latter measure accelerated reductions in marginal tax rates and reduced taxes on capital gains and dividends. A central campaign issue that has emerged is the fairness of these tax cuts. This column will address that issue with the data now available from the Congressional Budget Office (**CBO**) and the Urban Institute.

First , let's establish some foundation. The personal income tax is the largest source of revenue to the federal government. But it is not the only source of revenue. According to the tax policy center, individual income taxes are projected to contribute 44.2% of revenue in 2004. The remainder is generated primarily through payroll, excise, and corporate taxes.

The personal income tax is a progressive tax form. By that I mean that the personal income tax burden is proportionately heavier for the wealthier part of society. Conversely, payroll, excise, and sales taxes take a larger fraction of the wealth from lower and middle level earners. Therefore, any reduction in the personal income tax that does not address other revenue sources will make the overall tax system less progressive (more regressive). Indeed, this has occurred.

The CBO assessed the impact of the most recent tax cuts on the various income classes of US Taxpayers. The table below contrasts the fraction of income tax paid by different income groups before and after EGTRRA and JGTRRA. The column headed 2001 indicates the tax burden before the major tax legislation. The data indeed shows a mild shift in tax burden toward lower income quintiles in favor of higher income taxpayers. It should be emphasized that this

% of Individual Income Tax Paid by Different Income Brackets

	Baseline	New law in effect		Change in the overall tax burden 2001 -> 2005
Income Quintile	**2001**	**2004**	**2005**	
Lowest	**-1.8%**	**-1.6%**	**-1.6%**	**+0.2%**
Second	**1.2%**	**1.5%**	**1.6%**	**+0.4%**
Middle	**6.1%**	**6.4%**	**6.5%**	**+0.4%**
Fourth	**14.9%**	**15.3%**	**15.4%**	**+0.5%**
Highest	**79.5%**	**78.4%**	**78.1%**	**-1.4%**
Top 10%	**64.8%**	**63.5%**	**63.2%**	**-1.6%**
Top 1%	**32.6%**	**31.6%**	**31.4%**	**-1.2%**

Tax Cuts (continued)

shift is only relative and not absolute.

The recent changes in tax regime have reduced the tax burden in absolute terms to almost every US Taxpayer. The Urban Institute estimated aggregate changes in aftertax income as a result of tax law changes. As implied by the preceding table, higher earners did comparatively better but all benefited from the tax cuts. The table below indicates that everyone enjoyed a net increase in their aftertax income resulting from EGTRRA and JGTRRA.

My takeaway from the foregoing data is that income tax law changes were mildly regressive. All taxpayers benefited but the wealthy benefited a little bit more. If the top 1% of taxpayers had the same proportionate reduction in liability as the middle quintile (2.0% vs. 2.9%), federal receipts would have been about $13.7 billion higher. Not a big difference.

The argument for tax cuts hardly stops there. There is evidence that the total tax burden is becoming more regressive – but not because of income tax reform. The next article discusses some of those reasons. They have little to do with the individual income tax. In fact, state revenue sources are a big issue.

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Income Quintile	Change in aftertax income	Effective Tax Rate before EGTRRA	Effective Tax Rate Today	Net Change in Effective Tax Rate
Lowest	1.2%	3.7%	2.5%	-1.2%
Second	2.4%	9.7%	7.5%	-2.2%
Middle	2.4%	15.2%	13.2%	-2.0%
Fourth	2.4%	19.2%	17.3%	-1.9%
Highest	3.2%	23.2%	20.8%	-2.4%
Top 10%	3.3%	23.8%	21.2%	-2.6%
Top 1%	3.8%	25.2%	22.3%	-2.9%

The Growth of Regressive Taxes

There is no national sales tax. Yet most of us pay quite a bit on sales taxes every day. This regressive tax is among the top two revenue sources for most states. Excise taxes are also large income sources. Since both kinds of tax are based on consumption, their impact is relatively more severe on the poor and middle class. In Texas, nearly 80% of the state's tax revenue is generated through sales and excise taxes. That's over $20 billion! Yet state government's fastest growing source of revenue is its most insidious- casino gambling and lotteries. Only 15 years ago, New Jersey and Nevada were the only states allowing legalized gambling. There are now 49 states where some form of gaming is legal and, every year, state legislatures approve new forms.

Texas does not yet have casinos. Yet its lottery today ranks with the franchise tax as the state's fourth largest source of revenue. In 2003, lottery proceeds accounted for $1.4 billion. The Texas legislature has entertained bills to legalize casinos in the state. Were casinos to open here, revenue proceeds from gambling would expand dramatically. In Connecticut, gambling revenue just surpassed the corporate income tax as the state's third largest source of revenue.

The regressive payroll tax is assuming a greater share of federal receipts. Workers fund social security benefits with payroll withholding on their first $87,900. With the rather significant decrease in income tax rates since 2001, the importance of payroll taxes has increased dramatically. Since 2000, payroll taxes have gone from 32.2% to 40.0 % of federal revenue.

"Payroll, excise, and sales taxes take a larger fraction of the wealth from lower and middle level earners."