ANOTHER LOOK AT TAXPAYER RESPONSES TO THE 1993 ACT

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INTRODUCTION

WHILE THE LONG-TERM TREND IN THE U.S. HAS been toward lower individual income tax rates, the expiration of the 2001 and 2003 tax reductions would increase income tax rates, particularly for high-income taxpayers.[1] Under current law (as of early December 2012), the top individual income tax rate is scheduled to increase from 35 percent to 39.6 percent (40.788 percent including the effect of the Pease three percent floor under itemized deductions that affects most high-income taxpayers) starting in 2013. The top tax rate on capital gains will increase from 15 to 20 percent (21.188 including Pease) and the top rate on qualified dividends will increase from 15 to 40.788 percent. In addition, high-income taxpayers will be subject to a new 3.8 percent tax on net investment income, bringing the top rates to 24.988 percent for capital gains and to 44.588 percent for interest and dividends. Because these law changes are known well in advance, although subject to last-minute changes by Congress, taxpayers are likely have an opportunity to time their realization of certain types of income and deductions to reduce the effects of higher tax rates.

The potential increases in income tax rates for high-income taxpayers suggest that it may be helpful to re-examine the responses to the increases in the top income tax rates under the Omnibus Budget Reconciliation Act of 1993 (OBRA93). OBRA93 imposed additional tax rates on high-income taxpayers by increasing the top statutory individual income tax rate from 31 to 39.6 percent and the top corporate tax rate from 34 to 35 percent. In addition, the income cap on the hospital insurance (HI) tax was eliminated in 1994, further increasing marginal tax rates on high income taxpayers with self-employment or pass-through business income.

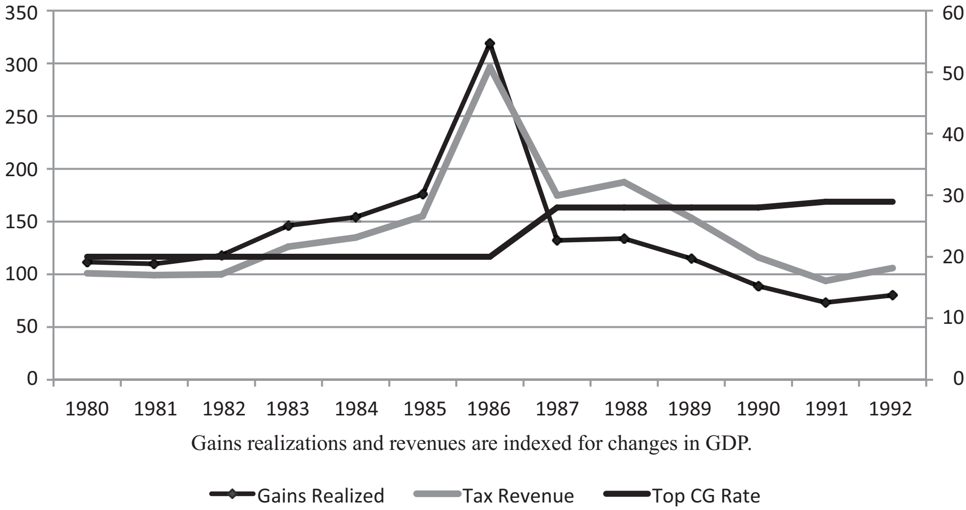
In this paper, we present preliminary evidence on the responses of different types of high-income taxpayers to the tax increases of OBRA93 in detail using a large panel of income tax returns. We document income shifting from 1993 to 1992 as high-income executives with large amounts of wage income anticipated the tax increases and accelerated their wages into 1992. But the wage response of executives appears to be primarily transitory, as their wages continued to rise in later years. While capital gains tax rates remained unchanged, capital gains realizations increased substantially, suggesting the possibility of income shifting from ordinary income to capital gains. S-corporation executives cut their salaries and instead increased their S-corporation distributions to presumably avoid the HI tax. We find similar responses for taxpayers with high income from partnerships.

Several studies have examined taxpayer responses to OBRA93. Feldstein and Feenberg (1996) concluded that in the first year under the higher rates, the decrease in taxable income of high-income taxpayers offset more than half of the revenue that would have been collected without the behavioral response, and that the deadweight loss of the higher marginal rates was about twice the increase in revenue. Other studies, however, argued that the majority of the response to OBRA93 was due to income shifting and that longer term responses were small and possibly nonexistent (Sammartino & Weiner, 1997; Goolsbee, 2000). Others have found evidence of modest behavioral responses (Carroll, 1998; Giertz, 2007, 2008). Our research contributes to this literature by highlighting the behavioral responses of high-income taxpayers in greater detail than has been done previously.

Before discussing our findings on OBRA93, it is also worth recalling taxpayer responses when the top capital gains tax rate increased from 20 to 28 percent under the Tax Reform Act of 1986 (TRA86).[2] Taxpayers had considerable time to prepare for this change as the conference agreement was reached August 16, 1986, then the bill was passed by Congress on September 26, 1986, and signed into law on October 22, 1986. As illustrated in figure 1, the magnitude of the change and perceptions that the higher rate could be permanent

*The views expressed in this paper reflect the views of the authors and do not necessarily reflect the views or policies of the U.S. Treasury Department.

Figure 1: **Response of Long-term Capital Gains in 1986**



Gains realizations and revenues are indexed for changes in GDP.

resulted in a doubling of capital gains realizations in 1986 in response to a 40 percent increase (8 percentage points) in the top capital gains rate.[3] While there are parallels between 1986 and 2012, there are also many differences. The TRA86 increase in the effective tax rate on capital gains was part of a broad reform in which the repeal of the 60 percent exclusion for capital gains was a key base-broadening provision that allowed substantial reductions in the tax rates on ordinary income. That is not the case in 2012 under current law. The 2013 increase in capital gains tax rates is potentially much larger: 60 percent, or 10 percentage points, including the 3.8 percent HI tax, and 100 percent, or 15 percentage points, including the proposal for a 30 percent rate under a Buffett Rule. In 2012, there may be more uncertainty about future capital gains rates since Congress could choose to rollover some of the expiring tax cuts, and such a decision could be made very late in the year. Nevertheless, it will be interesting to observe taxpayer behavior with respect to realizing capital gains in 2012, given the potential for a large increase in the top capital gains rate.

OVERVIEW OF THE OMNIBUS RECONCILIATION ACT OF 1993

OBRA93 increased ordinary income tax rates for high-income taxpayers by creating a new 36 percent rate imposed on taxable income over $140,000 for married taxpayers filing jointly (income $115,000 for single taxpayer) and by imposing an additional 10 percent surtax on taxable income over $250,000.[4] As a result, the top statutory income tax rate increased from 31 to 39.6 percent, while the remainder of the tax schedule remained essentially the same. In addition, the top rate on the Alternative Minimum Tax (AMT) was increased from 24 to 28 percent. In response to the higher rates, we might expect high-income individuals would decrease their reported taxable incomes. This response may have come, for example, through changes to labor supply, deferral of wage income into retirement savings, portfolio reallocations, increased deductions, or changes in tax evasion and avoidance. Because capital gains tax rates remained unchanged, high-income taxpayers had an increased incentive to receive income in the form of capital gains rather than wages or other forms of ordinary income.

In addition to the increase in tax rates, OBRA93 included other provisions that affected executives and other high-income taxpayers. A new provision capped the deduction for top executive compensation for publicly traded companies unless it is based on performance goals and meets certain requirements. Other provisions limited the ability of taxpayers to reduce taxable income in response to the higher rates. These include eliminating deductions for club dues, spousal travel and lobbying expenses, limiting deductions for business meals and moving expenses, reducing the amount of income that could be considered for benefits or contributions for retirement plans, and a provision to prevent the conversion of ordinary income into capital gains in certain cases.

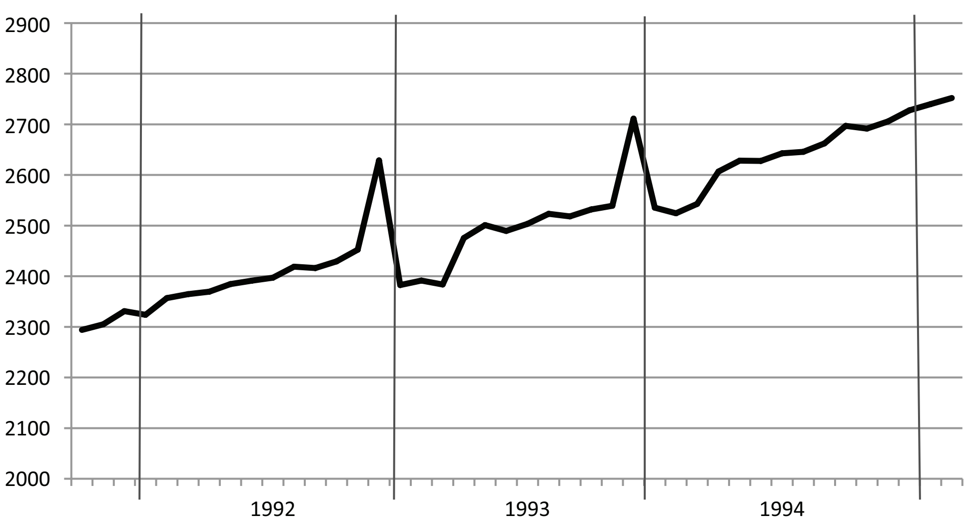
The events leading to OBRA93's enactment are important for this study, as they created incentives and opportunities for income shifting across tax years. Many key components of the tax act were publicized in 1992 (Kayle, 1992) and the basic elements of the act, a middle-class tax cut and an increase in high-income income tax rates (including a "millionaires" surtax), were included in a widely circulated Clinton campaign book.[5] In addition, Congress passed a tax bill in March 1992 that included these elements and details of tax changes that would likely be included if Clinton were elected.[6] OBRA93 was enacted in August 1993 and the tax changes were generally made retroactive to the beginning of the year.

Due to this timing of events, there was sufficient time and information to allow advance tax planning by high-income taxpayers. Following the 1992 election, taxpayers had nearly two months to make end-of-year changes. Tax planning ideas circulated and appeared in print. Thus, high-income individuals had incentives and opportunities to shift their income from 1993 to 1992. These high-income taxpayers also had an incentive to defer charitable contributions and other deductible items until 1993. The promise of a middle class tax cut eliminated these incentives for those with lower incomes.

A second incentive for income shifting came with the uncapping of income subject to the 2.9 percent HI portion of the payroll tax beginning in January 1994. This uncapping created an opportunity to save taxes by accelerating wage and self-employment income from 1994 to 1993. There would be no incentive for shifting deductions or income not subject to payroll taxes. This tax change would be particularly salient for taxpayers with large amounts of self-employment income, because they would be subject to the full 2.9 percent payroll tax, though half of this amount could be claimed as an above-the-line deduction. High wage recipients would only see the effects of a 1.45 percent HI tax on their pay statements. While economic theory suggests that their employers would reduce their gross wages by the employer's share of the tax, this effect would be less visible, and perhaps less salient, to wage earners.

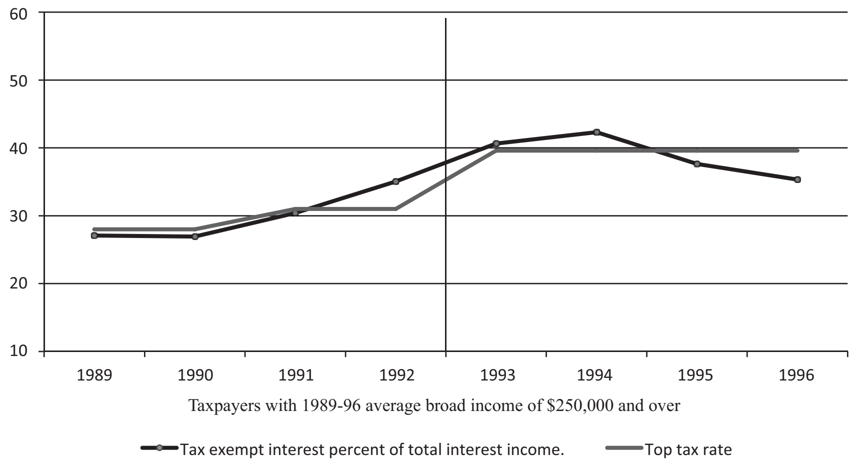
Two types of responses observed around the enactment of the 1993 act are illustrated in figures 2 and 3: the transitory acceleration of wage income

Figure 2: **Transitory Response: Taxpayers Accelerated Wages Ahead of the Tax Rate Increases**



Private industry wage and salary disbursements, seasonally adjusted

Figure 3: **A Longer Term Response: High-Income Taxpayers Shifted to Tax-Exempt Bonds**



ahead of the increase in tax rates and a longer term response of changing the composition of investment portfolios. Using aggregate monthly private sector wages reported in the national income accounts, figure 2 provides a dramatic illustration of the acceleration of over $15 billion of wages and year-end bonuses from 1993 to 1992 to avoid the effects of the anticipated increase in the top income tax rate. At the end of 1993, taxpayers shifted wages and bonuses a second time to avoid the increase in the HI tax beginning in 1994.

Figure 3 illustrates a second type of response likely to be longer in duration: portfolio reallocation. The graph shows that high-income taxpayers (average broad income at least $250,000) shifted into tax-exempt bonds as tax-exempt interest increased from about 27 percent of total interest income to about 40 percent. Other portfolio changes may also have included shifting to non-dividend-paying stocks and increasing contributions to tax-preferred retirement accounts.

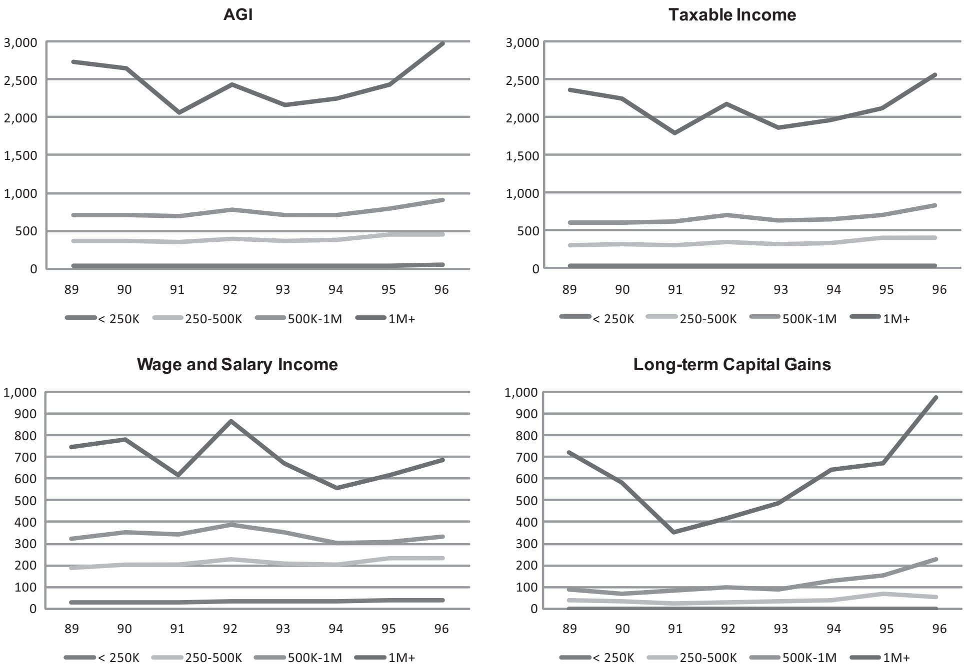
TAXPAYER RESPONSES TO OBRA 1993

Figure 4 presents graphical evidence of responses by high-income taxpayers to OBRA93 using a panel of approximately 87,000 nondependent taxpayers.[7] To examine differential responses of high-income taxpayers by income level, we split our sample of "relatively" high-income taxpayers into four adjusted gross income (AGI) groups: $50,000 to $250,000, $250,000 to $499,999, $500,000 to $999,999, and $1 million and over.[8] This classification is made according to average AGI from 1987 to 1991.[9] The top AGI class includes 9,379 taxpayers and is the group most likely to be responsive to tax changes.

The graphs of AGI and taxable income suggest some income shifting from 1993 into 1992, although the effect on overall income appears modest compared to 1986.[10] The declines in 1991 are likely primarily the result of the recession, but could reflect some shifting from 1991 to 1990. The graphs for wages and salaries suggest that the highest income group shifted as much as 15 percent of wages from 1993 to 1992 and, unlike AGI and taxable income, wages continued to decline in 1994, possibly reflecting shifting from 1994 to 1993. While average wages of the top group rose in 1995, they remained lower than before tax rates increased. Long-term capital gains[11] increased dramatically for the highest income group, accounting for almost all of the total increases in AGI and taxable income. While the magnitudes are diluted due to scale, there is also evidence of some income shifting and increasing capital gains for the second highest AGI group.

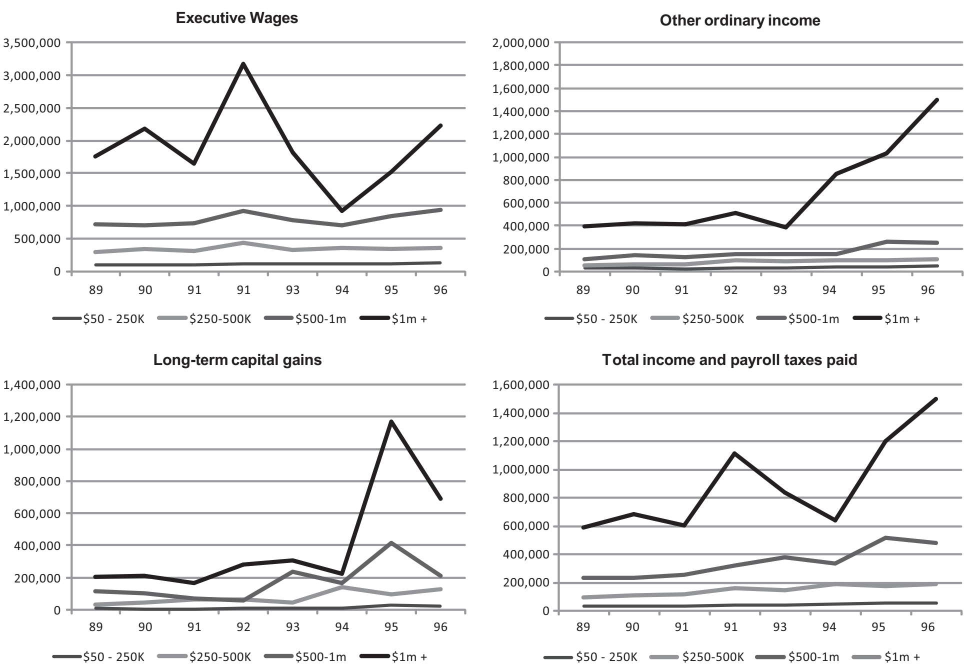
Figure 5 shows responses of a subgroup of taxpayers we examine in more detail — executives.[12] The graphs suggest that the highest paid executives shifted wage income from 1993 into 1992 and from 1994 to 1993. Average wages of this group increased by 92 percent in 1992 and then fell over 40 percent in both 1993 and 1994, in

Figure 4: **Response of Taxpayers by AGI Class**



Source: 1987 Family Panel, IRS Statistics of Income. Tabulations by the authors.

Figure 5: **Response of Executives by Average Wages in 1987-91**



Source: 1987 Family Panel, IRS Statistics of Income. Tabulations by the authors.

spite of these years being much better years from a macroeconomic standpoint. The drop in wages in 1991 likely reflects the effects of the recession and any acceleration of income ahead of OBRA90. The next highest-paid group of executives showed a similar pattern, but the percentage changes were much smaller. Executives with average salaries of $250,000 to $500,000 for 1987-1991 appeared to have accelerated income from 1993 to 1992, but not from 1994 to 1993, which was to be expected as they were much less affected by the uncapping of the HI tax.

Long-term capital gains increased dramatically for the highest wage group, consistent with a response to the differential in ordinary income and capital gains tax rates. Though not depicted here, the top three wage groups exhibited an increase in their share of interest income that is tax-exempt, similar to figure 2. Similarly, although the dollar values were quite modest, the average contributions to 401(k) retirement accounts of primary, and especially secondary, taxpayers increased significantly in percentage terms. In spite of apparent efforts to reduce tax liabilities by accelerating the receipt of income and shifting toward lower taxed capital gains, the income and payroll taxes of the highest paid executives increased significantly in 1995 and 1996, and their reported wages also began increasing rapidly.

A subgroup of executives consists of executives of S corporations whose responses were quite different and whose reported salaries showed no signs of shifting into 1992. Tabulations not shown indicate that the wages of the highest salaried S corporation executives (presumably their salaries as S corporation executives) decreased by almost half as tax rates increased while the share of income received as S corporation distributions, which were not subject to the uncapped HI tax, increased from about half to nearly 70 percent of combined salaries and distributions from the S corporation. Capital gains income reported by S corporation executives also increased dramatically. The total taxes, even of those with the highest initial wages, however, increased only slightly — much less than would be expected without accounting for behavior. We also observed that about 15 percent of executives with no previous S corporation income started receiving S corporation income after 1993, suggesting another tax planning response even though total reported income was much less changed.

While the uncapping of the HI tax appears to have induced shifting responses by the highest paid executives, it may have been even more salient to those with large amounts of partnership income. In analysis not depicted here, high-income taxpayers with large amounts of partnership income appear to have been more responsive to the uncapping of the HI tax than to the rate increases in 1993. These taxpayers adjusted their income composition away from active partnership and toward capital gains realizations. A dramatic increase in capital gains realizations beginning in 1993 is coupled with a dramatic decrease in active partnership income and the SECA tax base beginning in 1994 for these taxpayers. When considering total AGI, however, there are only small year-to-year changes, suggesting that the response of those with high partnership income was compositional, rather than a reduction in the total amount of reported income.

CONCLUSIONS

In this paper, we present evidence on how high-income taxpayers responded to the income tax rate increases they faced under OBRA93. Importantly, we find considerable heterogeneity in the responses to OBRA93 both across different types of income and across some different types of high-income taxpayers. Executives of C corporations responded primarily by shifting their income from 1993 to 1992 and by adjusting the composition of their income to reduce the effects of the higher statutory rates. In contrast, executives of S corporations did not show evidence of shifting wages to 1992, but gradually reduced wages and substituted S corporation distributions for wages. Thus, S corporation executives and high-income taxpayers with large amounts of partnership income seemed to be most responsive to the effects of the uncapping of the HI tax in 1994. One implication of these findings is that the analysis of the aggregate responses of high-income taxpayers to OBRA93 combines the responses of different types of high-income taxpayers, which we have shown are substantively different. These differences in responses may help to explain why some previous studies have estimated lower taxable income elasticities for OBRA93 than have been found for the reduction in tax rates during the 1980s.

In ongoing work, we plan to continue exploring in greater detail our descriptive analysis of the heterogeneous responses of different types of rich to the tax rate increases of OBRA93. We also plan to provide new estimates of the elasticity of taxable income that account for the heterogeneity in responses to OBRA93 by different types of high-income taxpayers highlighted in our graphical analysis here to obtain improved estimates of the elasticity of taxable income.[13]

Acknowledgements

The authors wish to thank David Albouy, David Joulfaian, Susan Nelson, Ivan Vidangos, Caroline Weber, participants at the 2011 International Institute of Public Finance Annual Congress and the 2011 National Tax Association Annual Meetings for helpful discussions about the project, and Siobhan O'Keefe for valuable research assistance.

Notes

1 This general trend toward lower tax rates is true of most other countries and recent proposals in some countries would also cause increases in individual tax rates.

2 The total effective increase in capital gains tax rates was somewhat larger because the repeal of the previous 60 percent exclusion meant that state income tax rates also increased significantly.

3 Burman et al. examined this transitory increase in capital gains realizations in 1986.

4 In addition, the so-called Pease phase-out of itemized deductions brought the new top effective marginal rate to 40.788 percent (39.6*(1.03)) for most high-income taxpayers.

5 The campaign book was Clinton and Gore (1992), *Putting People First: How We Can All Change America*.

6 This tax bill included a 36 percent rate starting at $140,000 of taxable income for married taxpayers (approximately $180,000 of AGI and taxable income of $115,000 for single taxpayers), and a millionaire surtax on taxable income exceeding $1 million. Another provision intended to affect high-paid executives capped the deduction for executive salaries at $1 million. The bill included middle class tax relief, most importantly in the form of a new child tax credit and a tax credit for Social Security taxes (FICA). Revenue estimates and summaries of the bill H.R. 4210, the "Tax Fairness and Economic Growth Acceleration Act of 1992," can be found in the publications section of the Joint Committee on Taxation's website, www.jct.gov.

7 The data are referred to as the Family Panel and are described in detail in Nunns et al. (2008) and Carroll (1998). The panel contains individual tax returns from 1987 to 1996. The initial sample is stratified to oversample high-income taxpayers.

8 We define high-income taxpayers as those with broad income of at least $100,000 if married, filing jointly at $50,000 otherwise. Broad income includes nontaxable sources of income reported on tax returns or information returns and is intended to measure economic income. This restriction is based on the 1987-1991 average of broad income so that the sample is selected on a measure of "permanent" income prior to any shifting around the 1993 act. This measure starts with total income as reported on tax returns and adds tax-exempt interest, untaxed Social Security and pension benefits, excluded savings bond interest, foreign excluded income, employer subsidies for child care, and net operating loss carryovers from prior years, but subtracts the adjustment for state tax refunds. Total income is before deduction of a number of adjustments in computing AGI. Our measure of broad income is, thus, more comprehensive than the broad income used in some prior studies, which is generally total income and similar to cash income measures used by CBO, Treasury, and others. Because relatively young individuals may exhibit atypical income growth patterns as they complete their education, we restrict observations to those who are over 25 years of age.

9 Because 1990 and 1991 are averaged together with the other years, any short-run shifting of income between these two years due to the tax rate changes in OBRA90 should cancel out.

10 To provide some perspective, a shift of about 10 percent of 1993 AGI into 1992 and 5 percent of 1994 AGI into 1993 would produce a smoothly increasing series after the 1991 recession year.

11 Long-term capital gains are those which benefit from any preferential rate for capital gains and equal the excess of any net long-term capital gain over any short-term capital loss.

12 Executives are identified from taxpayer-reported occupations on the Form 1040.

13 Preliminary regression results are reported in Auten and Kawano (2011).

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