TAX FOUNDATION

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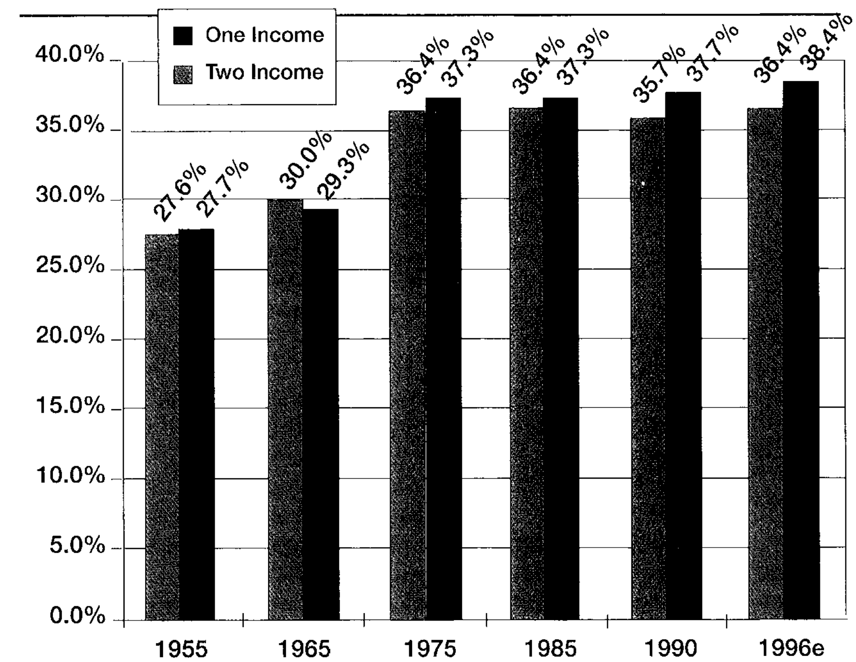
Economic Expansion Leads to Higher Taxes on Median One- and Two-Earner American Families

With increased prosperity comes — increased taxes. The Tax Foundation's annual analysis of the typical American family's tax burden shows overall tax levels increasing for the third year in a row, from 38.1 percent of income in 1995 to 38.4 percent in 1996. (See Charts 1 and 2.) The continuing increase in tax burden has occurred despite the fact that Congress has not enacted any major tax legislation targeting individuals since 1993. Rather, most of the increased burden has stemmed from our progressive tax system.

Chart 1: Taxes as Percentage of Income for the Median One- and Two-Income Families, 1955–1996



Source: Tax Foundation.

Senior Economist Arthur P. Hall's *Special Report*, "Economic Expansion Leads to Higher Taxes on Median One- and Two-Earner American Families," notes that the 1996 tax-burden level rivals the highest ever. For a dual-income family, the only years in which total taxes as a percent of income were higher than 38.4 percent were in the years 1980-1982. In those years, respectively, the shares were 38.6 percent, 40.6 percent, and 39.6 percent.

In terms of inflation-adjusted dollars, the $21,883 total tax burden that a median-income dual-earner family will bear this year will be the highest ever. Much of the increase in recent years, says Dr. Hall, reflects the progressive nature of the present tax system. In addition, as a comparison of Charts 2 and 3 demonstrates, two other tax trends are responsible for the jump in taxes since 1955: The upward trend in state and local taxation and the increase in the federal payroll tax used to fund social insurance schemes. State and local taxes combined have, as a share of income, grow about five percentage points from 1955 to 1996. Federal payroll taxes (individual share

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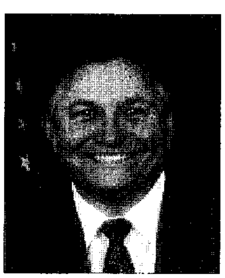
59th Annual Conference and Dinner Explores "Does Social Security Reform Have a Future?"

The issue of tax reform does not appear politically difficult for the majority of public policymakers. With public distrust of the current system running high, and with no clear link in the public mind between taxes and societal benefits, policymakers have in recent years been able to focus more on what kinds of changes to implement rather than whether tax reform should occur.

Don't, however, expect a similar consensus in the coming debate over Social Security reform. Politicians can't even agree on how to define Social Security. Is it a federal pension system, or merely another tax with no actual connection to the transfer payments to senior citizens?

One thing that most — and yet, not all — policymakers agree on: As a trust fund, Social Security faces critical financial problems in the next few decades. The Social Security Administration's annual report indicates that the baby boom generation will drive the system into bankruptcy if changes are not made. At the same time, there is a growing comprehension that the system offers participants a terrible return on their contributions.

With this fiscal threat in mind, and the recognition of a growing intergenerational schism in American society, the Tax Foundation's 1996 annual conference in New York City will examine the question, "Does Social Security Reform Have a Future?" The answer is by no means obvious.



Rep. Nick Smith

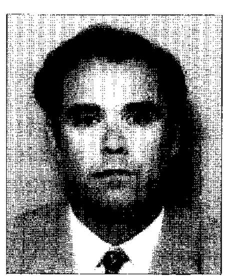
The conference is scheduled for the afternoon of Thursday, November 21, in the Waldorf-Astoria Hotel.

As keynote speaker, U.S. Represenative Nick Smith (R-Michigan) will kick off the conference at 12:15 p.m., providing an overview of where Congress stands on the issue of Social Security reform. Rep. Smith has been a leader in the movement to reform the nation's entitlement system, sponsoring H.R. 3758, a bill that would amend Social Security to provide for personal retirement savings accounts.

Brent Bahler, communications director of Citizens for a Sound Economy, will follow Mr. Smith, to present the results of a national survey on the issue.

Three afternoon sessions then follow:

Session One: "An Examination of the Need for Reform and the Macro Economic Benefits of Reform." Michael Tanner, Director of Health and Welfare Studies at the Cato Institute, will be the featured presenter, focusing his remarks on the serious financial problems that the system faces in the coming years, then addressing the economic advances that could be made through reform. Dr. Arthur P. Hall, Senior Economist at the Tax Foundation, will rely on his own research to formally comment on Mr. Tanner's address.



Dr. Ricardo Zabala

Session Two: "An Overview of the Chilean Reform Experience." Dr. Ricardo Zabala of Citibank, N.A., in Santiago, Chile, will relate his country's experience with privatization of the system of social insurance. An expert on pension fund management, Dr. Zabala served as Executive Vice President for Research and Corporate Planning for Administradora de Fondos de Pensiones, Chile's largest pension fund management company, prior to joining Citibank. Dr. John Goodman, President of the National Center for Policy Analysis and a prolific analyst on the issue of privatization, will formally comment on the address.

Session Three: "An In-Depth Discussion of the Choices That Must Be Made in Crafting Reform Legislation." Presenter Stephen Entin of the Institute for Research on the Economics of Taxation will tackle the tough issues — exploring what our federal legislators are up against to solve the Social Security crisis. Commentary will be provided by Mark Weinberger, Attorney-at-Law, Washington Counsel, P.C., and former Chief of Staff to the President's 1994 Bipartisan Commission on Entitlement and Tax Reform.

1996 Annual Dinner Award Recipients

U.S. Rep. Philip Crane (R-Ill.) will receive the Tax Foundation's 1996 Public Sector Distinguished Service Award at the 59th Annual Dinner in New York City November 21.

Rep.Phil Crane

Rep. Crane, who serves as Vice Chairman of the House Ways & Means Committee, was among the first members of Congress to propose indexation of the personal exemption and the standard deduction on federal income taxes, and was instrumental in having this included in the Economic Recovery Tax Act of 1981.

Dr. Norman Ture, founder and President of the Institute for Research on the Economics of Taxation (IRET), will be honored with the 1996 Tax Policy Service Award at the Annual Dinner.

Dr. Norman Ture

As Under Secretary of Treasury in the Reagan Administration in 1981, Dr. Ture helped craft and implement the Economic Recovery Tax Act of 1981, one of the largest tax cuts in the history of the country.

Recap of 1996 Media Coverage Shows Significance of Tax Foundation Public Education Efforts

The Tax Foundation was everywhere this election year — in daily and weekly newspapers, national and international news magazines, trade publications, newswire reports, and on television and radio stations nationwide.

"If consistent media coverage is a sign of strength for public policy groups, then the Tax Foundation must be one of the strongest groups pound for pound in the country," observed Foundation Executive Director and Chief Economist J.D. Foster.

Tax Foundation research was central to hundreds and hundreds of news stories in 1996, some of which embroiled the nonpartisan group in heated political disputes between candidates. Both Republican and Democratic candidates turned to Foundation work to support their campaign premises.

The year began with a flurry of publicity about tax reform, fueled by the initial volleys of election season. The Tax Foundation's analyses formed the basis of numerous articles and graphs. When the *New York Times* explored "How the Flat Tax Would Work, For You and For Them" (Jan. 21), the Tax Foundation's scenario for four hypothetical families was used as the primary source for the story's graphics. Similarly, the *Los Angeles Daily News* featured the Foundation's comparison of four households in a full-page graphic spread. When the *Chicago Tribune* contrasted the various tax reform plans on the table, it turned to the Tax Foundation research for the basis of its own article. And, in a lead editorial column titled "The Flat Tax: 'Nutty' It's Not" on the *Wall Street Journal* editorial pages, Foundation Executive Director and Chief Economist J.D. Foster's own opinion was featured alongside the likes of Milton Friedman's, James Buchanan's, and Arthur Laffer's.

As always, the Foundation's annual Tax Freedom Day announcement featured prominently in tax-filing stories around the country in mid-April. Tom Herman's weekly front-page *Wall Street Journal* Tax Report offered readers a teaser a few days before the announcement, unveiling the Tax Bite in the Eight-Hour Day — the amount of time it takes during an eight-hour work day to earn enough to pay your tax bill. Dozens of daily newspapers, from *USA Today* to *The Washington Times*, from the *Arizona Republic* to the *Arkansas Democrat Gazette*, made Tax Freedom Day the topic of their lead editorials. A *USA Today* "USA Snapshot" graph featured the Tax Bite in the Eight-Hour Day, and a London *Economist* magazine article focused on Tax Freedom Day as "one of the more colourful calculations" of the overall U.S. tax burden.

In numerous political campaigns in 1996, including the presidential campaign, tax and budget debates revolved around Tax Foundation analyses. Early in the election season, the Dole campaign started using the Foundation's Tax Freedom Day and median-income family data to support its call for changes in the tax system. For example, the campaign staged a "celebration" on Tax Freedom Day outside the Internal Revenue Service in the nation's capital (see photo, above).

The Washington Post (Front Page), May 8, 1996

At news conference outside the IRS, Senate Majority Leader Robert J. Dole talks about repeal of the gasoline tax on "Tax Freedom Day" — the day the average American has made enough to pay the year's taxes, the Tax Foundation says.

A few weeks later, however, the Dole campaign created some controversy when it used Tax Foundation tax burden comparisons between 1993 and 1996 to try to show the impact of President Clinton's tax increase. Journalists at CNN and *The New York Times*, among other major news outlets, called the Foundation to verify the numbers, and discovered that while Senator Dole's use of the numbers was techically correct, the campaign's conclusions were not those the Foundation would have arrived at. (Economic growth had more to do with the tax increases than the '93 tax hike, the Foundation concluded.)

More controversy arose in the media when, in the first presidential debate, the Republican candidate used Tax Foundation data showing that the average American now pays more in taxes than for food, clothing, and housing combined. Some members of the media, including the *Los Angeles Times* and CBS News, challenged these figures with other government data.

Media Coverage *continued on page 8*

Fundamental Principles of Tax Reform

By Rep. Phil Crane (R-Illinois)

As a former history professor, I have always looked to the enduring ideas of our Founding Fathers for guidance in making public policy. One of my favorites is the declaration "the power to tax is the power to destroy" made by Daniel Webster and John Marshall in the case *McCulloch v. Maryland*. Such a strong statement by two prominent men who shaped our government should have been better heeded by our nation's subsequent leaders. Instead, Congress and the President have seemed intent on testing the accuracy of the remark.

The U.S. Internal Revenue Code (the Code) is the modern-day manifestation of the power to destroy. Our tax system does harm to the principle of sound money management. The Code further injures the capitalist system on which our nation's economy is based.

> ***The U.S. Internal Revenue Code (the Code) is the modern-day manifestation of the power to destroy. Our tax system does harm to the principle of sound money management. The Code further injures the capitalist system on which our nation's economy is based.***

The Code has significantly degenerated since its inception. In 1913, only the most wealthy Americans paid income taxes. In fact, if the 1913 income tax were in place today, it would be comparatively quite generous. As Raymond Keating of the Small Business Survival Foundation has demonstrated, in 1994 dollars, a married couple would pay a one percent tax on their income over $60,000. Actually, those earning up to nearly $300,000 would pay only a one percent tax. The seven rate system (one percent to seven percent) would tax only incomes over $7.5 million at the top tax rate. On the business side, in 1909 the corporate tax rate was one percent, with a (in 1994 dollars) nearly $82,000 exemption amount.

Of course, the 1913 tax code did not last long. The outbreak of World War I led Congress to lower the exemption amounts, increase the lowest rate to six percent and the highest rate to 77 percent. During World War II, the top tax rate went to 94 percent and withholding was implemented. More recently, President Reagan lowered the top rate to 28 percent, until President Clinton increased it again to nearly 40 percent in 1993.

Not only has Congress and the President kept Americans guessing on tax rates, but computing your taxes has become much more complicated. Half of the individual filers now have accountants or lawyers prepare their returns. This is in spite of congressional efforts to "simplify" the Code. The cost of complying with federal tax laws is impossible to calculate, but estimates range from $75 billion $300 billion. Mobil Oil Corporation executives recently explained to our House Ways & Means Committee that they paid $10 million just to prepare their 6,300-page 1993 tax return.

Although Congress has attempted to make taxes "fair" by making the Code progressive, it is in fact the progressivity that has added to the complexity and inequity of the Code. While I agree that one's ability to pay ought to be considered with regard to one's tax burden, progressivity, as practiced by Washington social engineers, is more appropriately described as a vendetta to "soak the rich." What appears to be compassion is actually base envy. Those intent on making the rich "pay their fair share," despite their regular tinkering with tax rates and deductions, also cannot define the point at which the rich and businesses are paying their fair share of the tax burden. According to the Internal Revenue Service, in 1994, the top 25 percent of taxpayers paid 79.5 percent of federal income taxes. This 25 percent includes those with annual incomes of $43,000 or more. In my suburban Chicago district, $43,000 a year is middle class, but apparently Washington believes they are the rich who must be soaked.

This constant tinkering with federal taxes, instead of improving the

Not only has Congress and the President kept Americans guessing on tax rates, but computing your taxes has become much more complicated. Half of the individual filers now have accountants or lawyers prepare their returns.

Code, has actually injured America's prosperity.

Americans who save their money are penalized by two, three, four or five layers of taxes. Interest earned in a savings account is taxed. Dividends earned from stocks are taxed. When the stock is sold for a gain, the capital gains tax takes a share. However, the most immoral tax is that on one's estate. If a taxpayer attempts to pass along a family business or, even worse, has the audacity to die, the government penalizes the family. As the Tax Foundation previously mentioned, American families are not paying more in federal, state, and local taxes than they spend on food, clothing, and shelter combined.

American businesses are under attack from innumerable taxes and tax regulations. Armies of accountants and attorneys do nothing but defend American businesses from the onslaught. The corporate income tax is virtually incomprehensible with its varying depreciation schedules and the double-jeopardy alternative minimum tax.

As a nation founded in direct opposition to despotic taxes, we must scrap our oppressive Code. Beginning in the late 1970s and on into the early 1980s, I was among those first calling for comprehensive tax reform. In 1982, I introduced one of the first flat tax proposals. The Crane Tithe Tax called for a 10 percent flat tax. I explained that if God asks for no more than 10 percent, then Caesar should ask for no more.

Unfortunately, the political will for such a monumental change in tax policy has been absent since the Reagan Administration. It took a Republican majority in the House to resurrect the will to contemplate serious consideration of comprehensive tax reform.

Overhauling the tax code is not for the fainthearted. But modest changes to the Code will not address its fundamental deficiencies. The National Commission on Economic Growth and Tax Reform recommended that a new tax code should meet the principles of stability, fairness, neutrality, simplicity, visibility, and should provided incentives to work, save, and invest. I believe the flat tax best meets that description.

Since any new tax system we create may be undone by a future Congress, we must start with working to stabilize the tax system. To do this I propose a provision requiring that any increases in rates must have the vote of at least two-thirds of Congress. A low flat single-rate tax, with a poverty line level exemption, indexed to inflation, fairly applies the tax to all Americans. An elimination of all other deductions will keep rates low and keep social engineering out of the Code, maintaining neutrality. Such simplicity will allow taxpayers to keep the money that went to their accountants.

Furthermore, I believe that we should eliminate the practice of withholding. Taxes should be collected in the most painful and visible manner possible so that Americans are cognizant of the real cost of their government.

Business taxes, which are costs passed on to consumers, must be significantly reduced. I fear that the implementation of a consumption tax will lead, as it has in other countries, to an intrusive value-added tax. Thus, if businesses must be taxed, I prefer a low flat tax on profits after expenses.

Finally, the debate on tax reform has moved beyond whether we should to when and how we should implement a new tax code. While we must thoroughly study any prospective replacement, we must not let debates between proponents of the various replacement systems become so divisive so as to prevent us from reaching our goal of eliminating the current system and enacting comprehensive tax reform. While I believe that the flat tax has political and policy advantages over all the other plans, it is impossible to know the replacement on which Congress might eventually agree. However, if it embodies the principles of fairness, simplicity, neutrality, visibility, and stability, then we will have heeded the lesson of Webster and Marshall.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed in these columns are not necessarily those of the Tax Foundation.*

Median Family

Continued from page 1

only) as a share of total family income have grown about 6.2 percentage points from 1955 to 1996.

To a large extent, as Charts 3 and 4 show, this growth in tax burdens has crowded out other important parts of the family budget, such as saving. (Other items, such as food, are proportionally smaller due to efficiency gains in the marketplace.)

The families represented in Chart 2 adhere to the Census Bureau's broad definition of family — two or more re-

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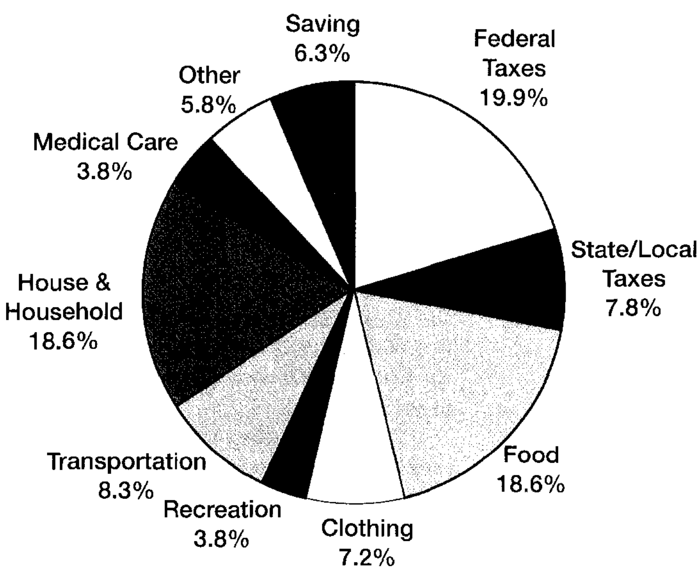
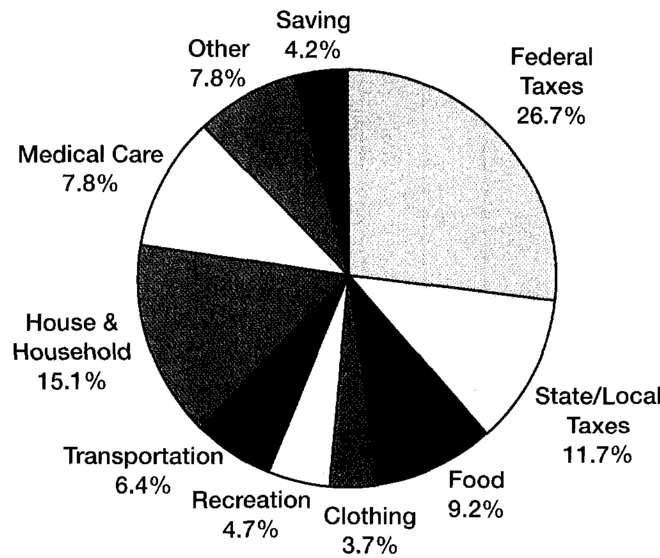
Chart 2: Representative Budget of Two-Income Family, 1956



Source: Tax Foundation.

Chart 3: Representative Budget of Two-Income Family, 1996e



Source: Tax Foundation.

Chart 4: Taxes and the American Family (Single and Dual Income Earners), 1955–1996

	1955		1975		1985		1996e	
	Single	Dual	Single	Dual	Single	Dual	Single	Dual
Median Family Income	$4,069	$5,250	$11,568	$16,058	$21,190	$33,411	$28,447	$53,091
Federal Income Tax	366	513	1,177	1,918	1,790	3,853	2,098	5,139
Payroll Taxes:								
Employee Portion	79	84	656	825	1,449	2,261	2,111	3,899
Employer Portion	79	84	656	825	1,449	2,261	2,111	3,899
Other Federal Taxes	315	407	582	808	791	1,247	1,234	2,303
Total Federal Taxes	839	1,088	3,072	4,376	5,479	9,623	7,554	15,241
Total State/Local Taxes	304	392	1,380	1,915	2,522	3,977	3,559	6,643
Total Taxes	1,143	1,480	4,452	6,291	8,001	13,600	11,113	21,883
After-Tax Income	3,005	3,854	7,773	10,592	14,638	22,072	19,444	35,107
Total Taxes as a Percent of Income	27.6%	27.7%	36.4%	37.3%	35.4%	38.1%	36.4%	38.4%
Inflation-Adjusted Total Taxes (1996$)	5,148	6,665	11,563	16,340	11,206	19,047	11,113	21,883

Note: The burden of federal and state corporate income taxes are included. After-tax income does not deduct employer's share of payroll taxes because the burden of the payroll tax is assumed to reduce income before the "gross" seen on paychecks. "Total taxes as a percent of income" is calculated by adding the employer's share of the payroll tax to the median family income.
Source: Tax Foundation.

FOUNDATION MESSAGE

Medicare Smiles and Political Wiles

J.D. Foster
Executive Director
& Chief Economist

Historians looking back on the 1996 presidential election may deduce the following truism to guide politicians evermore: Never demagogue a problem you have to solve after you win. The subject, of course, is Medicare.

As Charles Krauthammer wrote in *The Washington Post*, "The Democrats were merciless in their exploitation of Medicare", and, further, "Nor was there any secrecy about the dishonesty of the Democratic campaign on Medicare."

Even as the President's own head of the Health Care Financing Administration was describing the dire financial straights of the Federal Hospital Insurance Trust Fund, President Clinton and some congressional campaigns were hammering away at the simple theme that Republicans were a threat to the Medicare program and that only the Democrats could be trusted with its preservation.

Politically, it worked. The President was returned to the White House and Democrats whittled down the Republican margin in the House. The campaign of inactivity was victorious. Now, it's time to face facts.

For example, at the end of 1996 the Trust Fund will have about $121 billion in net "assets." (Of course, there are no assets in the Trust Fund, but let's not complicate matters too much.) At the beginning of 2001, the Board of Trustees estimate the Trust Fund will be about $53 billion in the hole. By 2006, the hole will be about a half trillion dollars.

The problem, of course, is that Medicare spending is increasing about 8 per cent per year. To stabilize the Trust Fund in the black will require slowing the growth rate to about 4 per cent per year if no initial cuts are made, or to about 3 per cent per year if $10 billion can be cut immediately. Translation: This is a big problem in the federal budget, but it is not intractable.

Where Medicare *has* become intractable in the past is in the politics. Medicare's impending collapse has been predicted for years. But the elderly are a potent political force not to be trifled with, which is why, of course, the Mediscare tactics were so effective for President Clinton, particularly in states like Florida and Arizona. Now, having held off a solution for so long, delay is no longer an option.

Republicans should work with the Democrats in crafting long-term reform of Medicare. To be in government is to govern. However, given their experience in the last campaign, it will hardly be surprising if the Republicans let the President and his congressional allies do all the hard work, take all the tough votes, and suffer all the political heat for the changes that must be made. Disdainful of bipartisan commissions and intolerant of tax increases, the Republicans seem inclined to a hard, passive, and perhaps avenging attitude.

This attitude, however, may be exactly what the President needs to turn the tables in his favor. Republicans are waiting to see what kinds of spending restraint the President will propose. But what if he proposes a modest slowdown in spending combined with a modest increase in the payroll tax. Republicans will oppose the tax increase, to be sure. But *then* who's in the way of reform? And, rather than the elderly turning on the President for proposing a spending slowdown, they will turn on the Republicans for proposing a bigger slowdown. The President will be proposing a little pain for everyone while the Republicans will be insisting on greater pain for a politically powerful special interest. In the context of a fiscal crisis where the President calls on us all to work together, the Republicans may find themselves losing a game they thought they would win. They may recall to mind the story about the lady and the tiger:

A smiling young lady from Niger,
Liked to ride on the back of a tiger.
She went for a ride
And came back inside,
With the smile on the face of the tiger.

How do Republicans keep their smiles while passing legislation? Total opposition is not an option because the Democrats are the minority party. In the Senate, for example, at least 15 Republicans will have to support reform to overcome the inevitable filibusters, and that assumes the President can get all 45 Democrats to agree to heavy restraint in Medicare growth spending.

The President will have to support a bill to get congressional Democrats to go along. Even Vice President Gore, who is certainly laying his plans to succeed the President, is inevitably tied to the outcome and all its attendant political fallout. The Vice President will obviously be pushing for the swiftest possible resolution to give him more time to effect damage control.

So, everybody is in the game, whether they like it or not because, in the end, Medicare reform must happen. As Winston Churchill once wrote, "Things do not get better by being left alone. Unless they are adjusted, they explode with a shattering detonation."

In planning their strategy, Republicans should review their own recent history, because the politics of Medicare reform parallel the political landscape following the 1994 election. At that time, Republicans thought they held a good hand, particularly on the budget. While they largely succeeded in resetting fiscal policy, they clearly failed politically, taking most of the blame and little of the credit for what followed.

Once again the Republicans think they have the President in a tough spot. And once again he may turn the tables if the Republicans fail to devise a strategy to carry them to the final bell. It will indeed be interesting to see who wears the smile when the tiger returns.

1996 Media Coverage Shows Tax Foundation Impact on Outreach

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The Foundation went public to vindicate Senator Dole's use of the statistic, with rebuttals appearing in an op-ed in *The Washington Times* and in articles in a number of other newspapers.

In the midst of the political campaign, Tax Foundation reviews of both the Dole and Clinton tax proposals formed the basis of many news analyses across the country. *Investors Business Daily*, for example, featured the research in several front-page articles.

Also, with Republican calls for "ending the I.R.S. as we know it," the Tax Foundation took a less rhetorical approach to the problem of tax reform. In an August 19 editorial column in *The New York Times*, Executive Director J.D. Foster observed that "attacking the I.R.S. misses the point. Whose fault is it that the agency is asked to administer a code that is incomprehensible.... (W)hose responsibility is it to supervise the agency?" While noting the IRS can do a better job, Dr. Foster concluded, "...it's up to the President and Congress to see that it does."

Tax Foundation research made news in non-campaign-related areas, also. Just a few of the more prominently featured Tax Foundation citations:

- Two Social Security studies, examining the federal retirement system from an investment perspective, captured the attention of a number of columnists, including *Newsweek's* Jane Bryant Quinn, syndicated columnist Doug Bandow, and *USA Today* editorial writers.
- An update of the Foundation's analysis of the costs of complying with the tax system — unveiled in Senior Economist Arthur Hall's testimony to Congress — made it into *The Washington Post*, among other major newspapers.
- A ranking of cities based on so-called "vacation taxes" made the news in *The New York Times*, the *Cincinnati Enquirer*, the *Tampa Tribune*, and several dozen other major dailies.
- Nationally syndicated columnists — such as James Glassman (Washington Post News Service), Doug Bandow (Copley News Service), Scott Burns (Universal Press Syndicate), and Kathy Kristof (Los Angeles Times Syndicate) — relied on basic Tax Foundation research for numerous columns during the year, as did syndicated graphic artists at such outlets as Gannett and the Associated Press.

Typical Family's Tax Burden Hovers at 38.4%

Median Family *continued from page 6*

lated people living in the same residence. Approximately 90 percent of the families represented in Dr. Hall's report are married couples with an average of about 1.3 children per family.

To calculate the total tax burden, Dr. Hall computed federal income taxes and payroll taxes directly off the family income. The burden of all other taxes (the array of federal excise taxes and customs duties, the federal estate and gift tax, the federal corporate income tax; and the array of state and local income taxes, sales taxes, excise taxes, property taxes, along with the array of miscellaneous state and local levies and fees) were calculated indirectly using formulas derived from national averages.

The Tax Foundation imputes to individuals the burden of all taxes paid by business.

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