Tax Watch

Summer 2005

TAX FOUNDATION Since 1937

Nation of Nonpayers: Forty Percent of Americans Outside Income Tax System

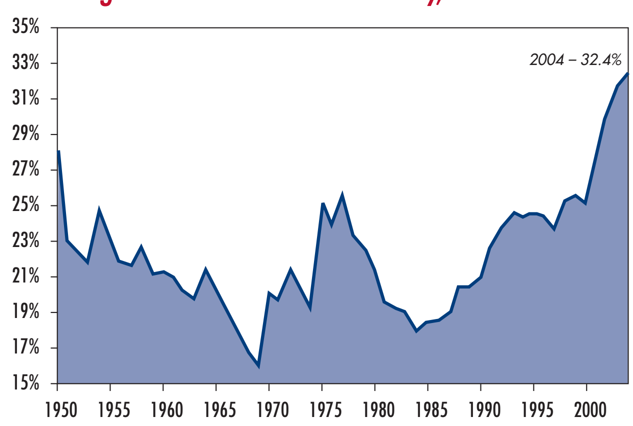
The first lesson of public finance is that good taxes have broad bases and low rates. But since 1980, the base of the federal income tax—the largest single source of federal revenue—has been shrinking dramatically.

According to a new analysis by the Tax Foundation, a record 42.5 million Americans who filed a tax return in 2004 had zero tax liability after credits and deductions. That amounts to more than one-third of the 131 million tax returns filed last year that owed zero federal income tax. And millions more paid next to nothing.

Why does this matter? According to Tax Foundation president Scott A. Hodge, the shrinking number of taxpayers bearing the nation's tax burden is a troubling development for any democratic society.

"America is becoming divided between a growing class of people who pay no income tax, and a shrinking class who bear the majority of the burden," said Hodge, co-author of the new analysis. "That makes tax reform politically difficult, since reform would require drawing these non-payers back into the tax system in order to broaden the tax base."

Percentage of Filers with No Tax Liability, 1950–2004



Source: IRS, Tax Foundation

The Incredible Shrinking Tax Base

Despite the charges of critics that the tax cuts enacted in 2001, 2003 and 2004 favored wealthy Americans, these cuts actually reduced the tax burden of low- and middle-income taxpayers, and shifted the tax burden onto wealthier taxpayers.

"The number of Americans who paid no income taxes because of deductions and credits in the tax code has varied greatly since 1950," said Hodge. "But in recent years it has spiked to record levels, and the trend line does not appear to be slowing."

In addition to the 42.5 million non-payers, some 15 million individuals and families earned some income last year but not enough to be required to file a

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Message from the President: Educating Congress on International Tax

Each year for the last 15 years the Tax Foundation has led a delegation of senior congressional tax staff to meet with European tax authorities. The event in the past has proven to be an effective way to facilitate sharing of knowledge between U.S. and European tax policymakers, and this year's event was no exception.

This June our delegation met with policymakers in Prague, Czech Republic; Paris, France; and London, England. At our first stop in Prague, we heard from Petr Mach, Executive Director of the Center for Economics and Politics and an advisor to the Social Democratic Party, about his plan to reform the Czech tax system.

Mach wants to change the current system, which levies different rates on personal income, corporate income, and consumption, to levy a flat tax of 15 percent on income and consumption. His proposal would also eliminate all special tax credits and deductions.

The similarities between the Czech and U.S. tax reform debate are striking. The geography may be different, but the issues are virtually identical. The economics of tax reform seem irreconcilable with the politics of tax reform. The Czechs, however, may be feeling more pressure from their regional neighbors that have adopted flat taxes, such as Slovakia (19 percent flat tax), Russia (13 percent flat tax), and some of the Baltic states. It may take similar international competition—like the recent German initiative to lower corporate tax rates—to get comparable movement in the U.S.

Our second stop was Paris, France, where participants met with leaders from the Organization for Economic Cooperation and Development for a briefing on global trends in tax policy, as well as the OECD's effort to encourage nations to remove tax obstacles to cross-border investments.

Our final destination was London, where we wrapped up our week-long delegation with British officials who will be responsible for setting Britain's EU policies during their presidential term.

Each year, the European tax delegation is a grueling work schedule. But the goal of an educated congressional staff on international tax—and improved future tax policy—makes it well worth the effort.

Cordially,

Scott A. Hodge

Tax Watch

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TAX FOUNDATION Since 1937

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New Prohibition: Rising Excise Taxes, Growing Black Markets

States hoping to plug their budget gaps with cigarette tax revenue may end up spawning another problem—growing smuggling and crime as cigarette buyers go underground.

That's the finding of a new study by Prof. Richard Wagner of George Mason University, "State Excise Taxation: Horse-and-Buggy Taxes in an Electronic Age," Tax Foundation Background Paper No. 48.

"Most selective excise taxes are not about charging the users of governmentally provided services directly for their usage," said Wagner. "They are methods of discriminating against some taxpayers in favor of others."

"Unfortunately," he added, "they cause a great deal of harm both to taxpayers and to the state governments who rely on them."

Among excise taxes, states raise the most by taxing cigarettes, alcohol, gasoline and telecommunications. Of these, cigarette taxes have increased most precipitously during the last 10 years—despite abundant evidence that the high tax levels are creating a host of problems:

> *"Cigarette taxes have increased during the past 10 years—despite abundant evidence that the high tax levels are creating a host of problems."*

- Cigarette tax revenue estimates are rarely met, causing budget problems.
- Bonds sold against future tobacco settlement revenues are unattractive except at preposterously high interest rates, and even then they are downgraded by the rating agencies.
- In a replay of Prohibition-era social decay, law-abiding citizens learn to break the law routinely, and states respond by adopting intrusive and sometimes abusive tactics to catch them.
- Organized criminals and terrorist cells begin trafficking in smuggled cigarettes, and the states spend prodigiously to catch them.
- Businesses and jobs, along with their tax revenue, are lost to interstate competition.

"While cigarette excise taxes raise a modest amount of revenue, they can also cause kidnappings and even murders, encourage organized crime, and divert law enforcement away from more productive activities," said Wagner.

The growth of these destructive consequences brings state governments to a crossroads, according to Wagner. In one direction: state governments that use invasive, threatening, expensive and ultimately futile tactics to enforce high tax rates. In the other direction: innovative, service-oriented state governments that know they must compete with their neighboring jurisdictions by levying reasonable taxes.

Revenues Go Up in Smoke

"Cigarette taxes are already an unreliable revenue source," said Scott Hodge, President of the Tax Foundation, "and that unreliability will surely get worse as tax rates climb and more customers are forced to shop for low-tax cigarettes from legal and illegal sources."

States like New Jersey have further compounded the problem by selling bonds based on future revenues from the master tobacco settlement. Payment on these bonds depends on high taxable cigarette sales, but at the same time the state has depressed those sales by raising its cigarette tax to $2.40 per pack, second highest in the nation.

"State governments have become more addicted to tobacco taxes than smokers are to smoking," said Hodge. "It creates a vicious cycle of rising taxes followed by rising enforcement problems."

View the full study at http://www.taxfoundation.org/publications/show/522.html.

Nation of Nonpayers
(continued from page 1)

tax return. That means that in total, some 57.5 million Americans who earn some income currently pay no federal income tax.

"Even the 57.5 million figure is not the actual number of people outside the tax code, because one tax return often represents several people," said Hodge. "When dependents of these tax filers are counted, roughly 120 million Americans—40 percent of the U.S. population—are outside of the federal income tax system."

Considering how fast the number of Americans outside the income tax system is growing, it's important for lawmakers to understand who they are.

Who Pays No Income Tax?

"Broadly speaking, the 42.5 million zero-tax filers are low-income, young, female-headed households, part-time workers, and beneficiaries of the $1,000 per-child tax credit or the Earned Income Tax Credit (EITC)," said Hodge.

Ninety-six percent of the 42.5 million non-payers earned less than $40,000 per year, and the majority work part-time or full-time for only part of the work year. More than one-third are younger than age 25, and 54 percent are younger than age 35.

Deductions and Credits Are the Cause

What's causing the increase in Americans with no tax liability? The main culprit is the growth in deductions and tax credits in recent years.

Many of the credits and deductions are familiar to most taxpayers: the personal exemption, the standard deduction, the child tax credit, the home mortgage interest and charitable contribution deductions, etc.

By taking advantage of these credits and deductions taxpayers can cut their tax liability—sometimes all the way to zero or below since some credits are refundable.

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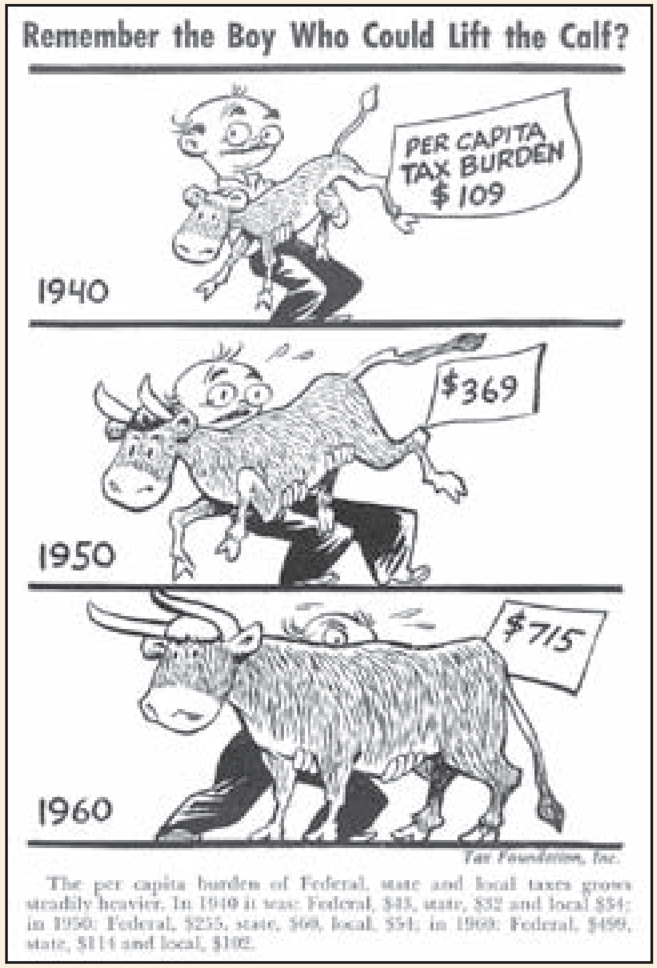
From Our Archives: 1960



Source: *Monthly Tax Features* (December 1960) Tax Foundation.

Our Economists in the News

Wall Street Journal "How to Skin a Wolverine"
Boston Globe "State seeing end to fiscal downturn"
Washington Post "Louisiana Alcohol Taxes Low"
CNN Money "America's fastest rising taxes"
Investor's Business Daily "Running from Risk"
MSNBC's "Connected Coast to Coast"
Akron Beacon Journal "Cigarette tax has smokers fuming mad"
USA Today "California could be golden for 12-state Mega Millions"
Christian Science Monitor "States try to ease property-tax rise"
Kansas City Star "It's the dreaded 'T' word"
Charlotte Observer "N.C. tax climate bad for business"
CNBC's "Kudlow & Company"
Providence Journal "Tax-relief program again strained"
Florida Sun-Sentinal "Taxing Wealth"
Minneapolis Star-Tribune "Getting past the gridlock"
Boston Globe "Northeast's return on federal taxes continues to shrink"

Visit our "Press Room" at www.taxfoundation.org/press/

Tax Foundation Offers Guidance to Tax Reform Panel

On April 29th the Tax Foundation submitted comments to the President's Advisory Panel on Federal Tax Reform on ways to make the federal tax code simpler and more economically neutral. An executive summary of the submitted comments is below.

Judging from their responses to a recent Tax Foundation/Harris Interactive poll, Americans are ready to support fundamental tax reform. A majority of American adults believe federal taxes are too high, the tax code is too complex, and the income tax system is unfair. A majority support simplification even if it means giving up some deductions and exemptions.

The first step toward reform is to understand how our progressive income tax system interacts with recent demographic changes. If we look at who comprises the wealthiest 20 percent of taxpayers, we find they share many traits with our traditional notions of "middle class":

- They are overwhelmingly dual-income married couples;
- They live in high-cost metropolitan areas and have correspondingly high nominal incomes, but average living standards;
- They are older workers, at or nearing their peak earning years;
- They are college educated and have professional jobs; and
- They have business income.

The current tax system penalizes these groups. These families are taxed at the highest income tax rates because our progressive tax system is not fully adjusted for such things as cost of living, age, education, or the number of incomes in a household. Tax reform should attempt to make the tax code more neutral to these demographic traits.

"The first step toward reform is to understand how our progressive income tax system interacts with recent demographic changes."

The only way to mitigate the punishing effects of our current progressive rate structure on dual-income couples, older workers, the college educated, business owners, and families living in high-cost communities is to enact a single-rate tax levied on consumption or on income.

Such a tax should be set at a low rate, applied to a broad base, and have as few deductions as is politically possible. Single-rate tax systems have proven successful in Central and Eastern European countries in recent years, and would likely enjoy similar success in the United States.

The biggest obstacle to tax reform may not be the army of Washington lobbyists who will fight to protect their deductions and exemptions. The most serious obstacle to reform is the fact that America has become divided between a growing class of people who pay no income taxes and a shrinking class of people who are bearing the majority of the burden. The widening gulf between the "payers" and the "non-payers" poses a dilemma for this panel.

View the full comments ("The Case for a Single-Rate Tax: Why Our Progressive Tax Code is Inconsistent with the Changing Face of American Taxpayers" by Scott A. Hodge) at http://www.taxfoundation.org/publications/show/420.html.

Unequal Burdens (continued from page 4)

Of the 42.5 million tax returns that pay no income taxes, 53 percent received some form of a refundable credit, either the EITC or the child tax credit. In 2004, Uncle Sam paid out about $33 billion for the EITC and $9 billion for the child credit.

What It Means For Tax Reform

At a time when the President has called for tax simplification and reform, Hodge points out that the growing number of Americans outside the income tax code poses a dilemma for the Bush tax team.

"These findings raise serious questions about the future of the U.S. income tax system," said Hodge. "Are any tax reforms possible when most of the tax burden is increasingly borne by a shrinking pool of taxpayers who—at least on paper—appear to be upper-income?"

If the goal of tax reform is to expand the tax base while lowering rates, the difficult problem facing the President's Advisory Panel on Federal Tax Reform is how to craft a plan that doesn't raise taxes on those who now pay nothing, but also doesn't "cut taxes for the rich" who now pay everything.

"There is no easy answer," said Hodge. "Especially if the Tax Reform Panel remains committed to revenue-neutral tax reform plans."

View the full analysis at http://www.taxfoundation.org/news/show/542.html.

Tribute to W. Bruce Thomas

On June 6th W. Bruce Thomas, longtime friend and Board Member of the Tax Foundation and retired vice chairman and chief financial officer of USX Corporation, died after a struggle with cancer. He was 78.

A native of Michigan, Mr. Thomas served in the Air Corps during World War II. He graduated *magna cum laude* from Western Michigan University and received a juris doctor degree from the University of Michigan Law School. He also attended the University of California and completed graduate work at the New York University Law School.

Mr. Thomas served on the Tax Foundation's Board of Directors throughout the 1980s, and served as Chair from 1982-1985. In addition to his service on the U. S. Steel and Marathon Oil Company boards, Mr. Thomas served as a board member for dozens of organizations including Chemical Bank, Chase Manhattan Bank, Adela International Corporation and others.

Mr. Thomas is survived by his wife of 55 years, Phyllis Smith Thomas, and his son, daughter in law, niece, and two grand children. His outstanding leadership and support will be missed throughout the tax policy community.

In the Words of His Friends

"Bruce Thomas … was a pleasure to deal with, always generous with his time, and was willing to work very hard to help the Tax Foundation succeed. I believe he had a genuine concern for the condition of the country and a strong belief that the Tax Foundation could make a positive difference in the world. He will be sorely missed."

— Wayne Gable, Chairman of the Board of Directors, Tax Foundation

"Over the years the Tax Foundation has been associated with great figures in public and private life, but few gave as much to the vitality of the organization as Bruce Thomas. Bruce was a true leader for many years and continued to care deeply about our mission even in retirement. I'm glad to have known him in a small way over the past few years. He was a genuinely good man and will be missed."

— Scott A. Hodge, President, Tax Foundation

Tax Foundation to Supreme Court: Protect State Tax Competition

Handing out tax incentives to companies may be bad tax policy, but a recent court ruling aimed at stopping the practice may do more harm than good.

That's according to an *amicus brief* recently filed with the United States Supreme Court by Tax Foundation staff attorney Chris Atkins.

"The ruling in the case of *Cuno v. DaimlerChrysler*—which invalidated an Ohio tax credit for business investment—is legally flawed and sets poor precedent for tax policymakers," said Atkins.

The tax credit in the Cuno case gives a corporation a tax credit for building an Ohio facility. The Sixth Circuit Court of Appeals ruled that it illegally discriminated against interstate commerce. The case has been appealed to the Supreme Court.

"The irony of *Cuno* is that it imperils good state tax reforms while simultaneously allowing the harmful practice of handing out tax bonuses to continue," said Atkins.

In an earlier Tax Foundation analysis Atkins argues the *Cuno* decision is overly broad, may prevent good tax competition as well as bad, and allows lawmakers to continue to hand out cash subsidies.

"*Cuno* is not the answer for those who want the states to stop carving special incentives into their tax codes," said Atkins. "That is why we are asking the Supreme Court to review and reverse the *Cuno* decision."

View the full brief at http://www.taxfoundation.org/publications/show/955.html.

Making Taxes Simple: Do Corporate Taxes Hurt Growth?

In theory, higher corporate tax rates should decrease economic growth rates. Why? Because they reduce incentives to take risks, accumulate capital and engage in entrepreneurial activity, making society less wealthy over time.

But is the theory correct in practice?

According to a recent paper from Young Lee and Roger H. Gordon in the June 2005 issue of the *Journal of Public Economics*, the answer is yes.

Examining 27 years of cross-country data, the authors found that lowering corporate tax rates can dramatically boost economic growth. After controlling for the effects of education, population growth, openness to trade and other factors, Lee and Gordon found that corporate tax rates are significantly negatively related to economic growth.

And the effect wasn't small—they conclude that a cut in corporate tax rates of ten percentage points boosts annual growth by about 1.1 percentage points.

According to the OECD, the United States currently has the third highest corporate income tax rate in the world. If Lee and Gorden are correct, cutting the U.S combined state and federal corporate tax rate from roughly 40 percent to 30 percent we could boost U.S. economic growth by around 1.1 percent per year. That may not sound like much, but simple arithmetic shows it's enough to double our nation's wealth roughly every 63 years.

Source: Young Lee and Roger H. Gordon, "Tax Structure and Economic Growth," Journal of Public Economics, Volume 89 (2005), Issue 5-6.

Leave a Legacy of Sound Tax Policy: DonorsTrust

It's all too common for philanthropic capital—especially from foundations—to stray from the original donor's wishes and the free-market principles that made their philanthropy possible in the first place.

As an antidote to this drift, DonorsTrust (www.donorstrust.org) was established to ensure the intent of donors who are dedicated to the ideals of limited government, personal responsibility, and free enterprise.

> *"It's common for philanthropic capital to stray from the free-market principles of the original donors."*

DonorsTrust provides an innovative charitable vehicle for donors who wish to safeguard their charitable intent to fund organizations like the Tax Foundation that work to preserve America's founding principles.

How It Works

DonorsTrust offers a tax-efficient charitable vehicle called a donor-advised fund—what you might call a "charitable bank account". Donors may give cash or appreciated securities to a personally named account, receive an immediate tax deduction for the amount of their contribution, and then invest the dollars in a pooled investment portfolio.

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More importantly, DonorsTrust provides a protective boundary around each of these accounts. Donors can only recommend grants to organizations preserving the American ideals of liberty as understood by our Founding Fathers. Client donors also write a donor intent statement that expressly states their values. DonorsTrust will never approve a grant that contradicts our mission or the donor's written intent.

Since inception, DonorsTrust has received more than $46 million in contributions from donors who are dedicated to preserving a free society. And at the recommendation of our client donors, DonorsTrust has granted out over $17 million to more than 200 organizations that include religious organizations, research hospitals, private schools, universities, fraternities, volunteer fire departments, and museums in addition to public-policy organizations.

For more information about supporting groups like the Tax Foundation through DonorsTrust or safeguarding your charitable capital, please call DonorsTrust at (703) 535-3563 or visit www.donorstrust.org.