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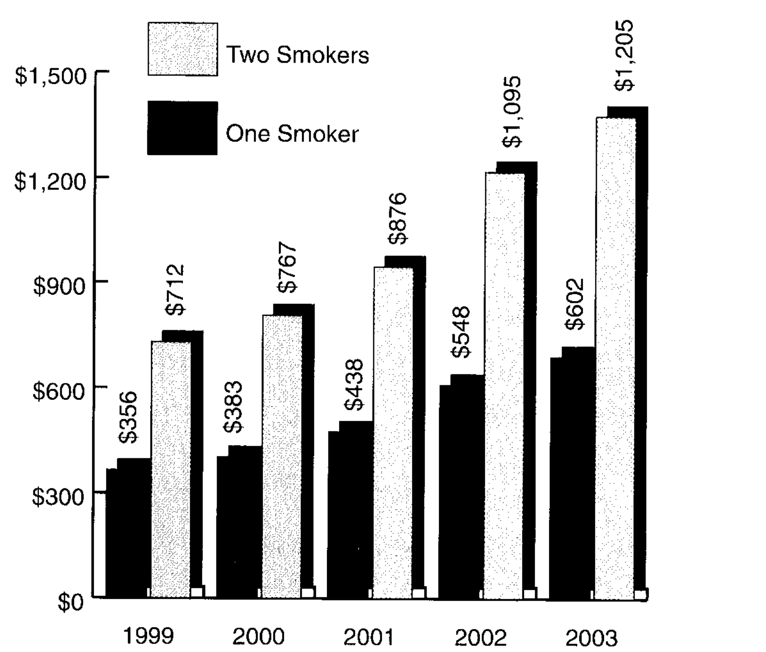
Senate Tobacco Legislation Would Add Hundreds of Dollars to Smokers' Tax Bills

Annual Cost of the McCain Bill for Average One- and Two-Smoker Households under the Baseline Scenario, 1999-2003 (1998 Dollars)



Source: Tax Foundation.

A new report out by the Tax Foundation projects that enactment of the Senate's tobacco legislation would increase cigarette excises $356 for the average single-smoker household. By 2003, the annual tax increase for that household could jump to $602. (See Chart 1.) Households with $15,000 or less in annual income would be hit the hardest by the tax increase. (See Chart 2.)

In a new *Special Report* titled "How the McCain Bill Affects Smokers' Wallets and the Underground Cigarette Market," Senior Economist Patrick Fleenor projects the average impact on one- and two-smoker households of the cigarette tax hikes in the National Tobacco Policy and Youth Smoking Reduction Act, sponsored by Senator John McCain (R-Ariz.).

The bill includes the creation of a National Tobacco Settlement Trust Fund, into which industry would have to pay billions of dollars each year. In order to make these payments, the bill requires that tobacco companies apply a "licensing fee" onto each pack of cigarettes, starting at 65¢ per pack in 1999 and reaching $1.10 by 2003. The bill also sets targets for reducing the number of teenage smokers in the U.S., with fines assessed against the

Tobacco Taxes *continued on page 2*

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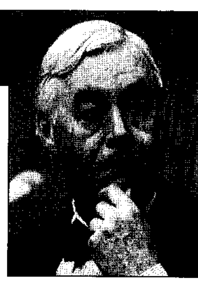


Restructuring and Reforming the Internal Revenue Service

Senator Daniel Patrick Moynihan (D-N.Y.) **4-5**

Foundation Examines Senate Tobacco Legislation

Tobacco Taxes

Continued from page 1

tobacco firms if the goals are not met in a timely fashion.

Mr. Fleenor analyzes the effect of the cigarette tax hike on different income groups, and provides several financial scenarios under the legislation, depending on the degree underage smoking ceases and the extent to which cigarette prices rise.

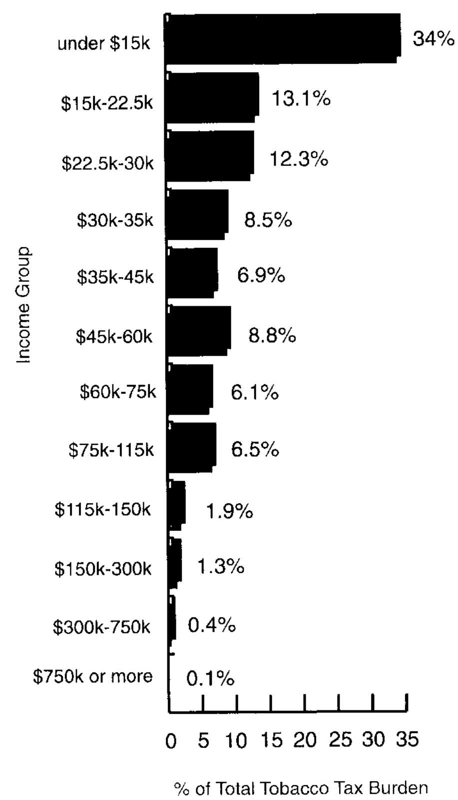
For example, under Mr. Fleenor's "Scenario One," cigarette prices rise just enough to reflect industry payments to the government, and underage smoking declines by the levels specified in the legislation. Mr. Fleenor projects that in this case, the cost to consumers over five years would be $94.5 billion (in 1998 dollars), with roughly a third of that cost picked up by Americans earning less than $15,000 a year. That translates into $356 in additional taxes for a single-smoker household in 1999, and an increase of $602 by the year 2003. (See Chart 3.)

Under "Scenario Two," teenage smoking declines by less than is mandated in the legislation, and industry fines are assessed, as called for in the legislation. Here, consumers would pay $98 billion in additional taxes between 1999 and 2003, with low-income earners again bearing much of the burden of the price increases. As a result, starting in 2002 — the first year that government fines will be assessed — the one-smoker household would pay more taxes than under Scenario One.

Finally, under "Scenario Three," Mr. Fleenor relaxes his assumption that cigarette prices will rise only enough to cover industry fees. Many analysts expect, as a result of advertising restrictions, antitrust exemptions, and other anti-competitive provisions within the bill, that cigarette prices could in fact rise much higher. A price hike of $1.85, says Mr. Fleenor, would lead to dramatically higher tax bills for one-smoker households as early as 2000. That household's tax bill could be $526 greater in 2000 than it is today — a significant increase over the $383 increase in Scenario One.

Using the consequences of cigarette tax hikes in Canada, Europe, and Asia, Mr. Fleenor also predicts the rise of a flourishing illegal cigarette market in this country, with untaxed or low-taxed tobacco products being smuggled into this country and sold at "discount" rates.

Chart 2: Distribution of "Scenario One" Tobacco Tax Increase by Income Group



Source: Tax Foundation.

Chart 3: Average Annual Cost Per Household of the National Tobacco Policy and Youth Smoking Reduction Act, 1999 – 2003 (1998 Dollars)

	1999	2000	2001	2002	2003
Scenario I					
Single Smoker	$356	$383	$438	$548	$602
Two Smokers	712	767	876	1,095	1,205
Scenario II					
Single Smoker	356	383	438	598	653
Two Smokers	712	767	876	1,197	1,307
Scenario III					
Single Smoker	356	526	660	836	1,011
Two Smokers	712	1,053	1,320	1,672	2,022

Source: Tax Foundation.

What to Do with the Federal Budget Surplus?
Foundation Examines Congressional Debate Over the Options

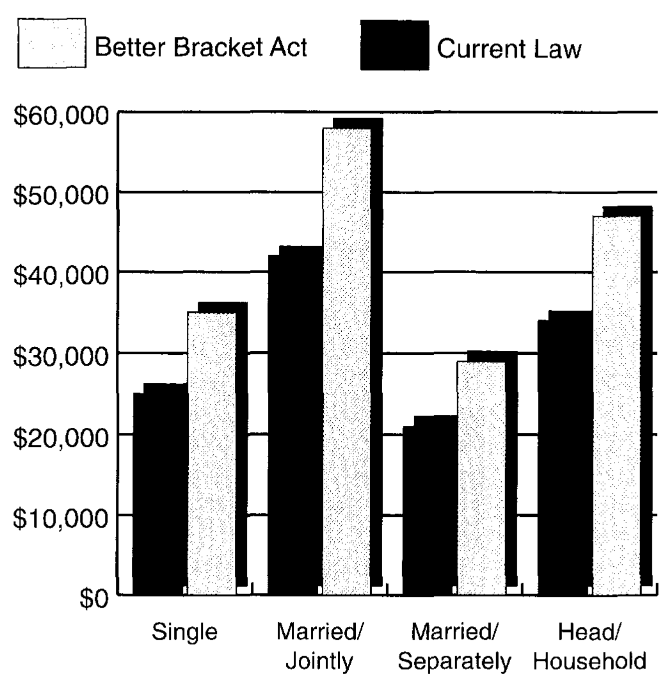
For the first time in 30 years, the federal budget is effectively in balance. This unexpectedly good news about the budget deficit has renewed the debate between Congress and the President over fiscal policy. A new *Background Paper* by Senior Economist Claire M. Hintz focuses on one of the primary options for dealing with the surplus: tax relief. Ms. Hintz sees the tax reduction options falling into several categories: Reductions in marginal tax rates; changes in the payroll tax; relief from the marriage penalty; reform of the alternative minimum tax (AMT); and proposals that can be characterized as tax relief for savings — capital gains tax reductions, estate tax relief, expanded IRAs, and interest and dividend exclusions.

Among her conclusions:

- While it has become a politically popular cause, marriage penalty tax relief is a narrowly targeted tax cut, designed to deliver tax relief to married taxpayers. Most of the current legislative proposals cut taxes on married couples whether they are presently strapped with a marriage penalty or not. As such, they offer inefficient remedies for the problem they are supposed to address.
- Indexing the AMT for inflation will protect many taxpayers, but it will not reduce the compliance burdens that the AMT imposes on taxpayers through the necessity of calculating a second, separate income tax base and liability. Nor will it change the fact that many more taxpayers than those actually liable for AMT must calculate it to determine if they are liable or if it reduces their credits.
- One of the fundamental flaws of the current income tax system is that it is heavily biased against saving. In most cases, income that is saved faces multiple layers of taxation, including as it is earned and again on the interest, dividends, corporate income, and capital gains it generates. These layers of additional taxation are in part responsible for the low level of personal savings in the U.S. In recognition of this bias, over the years Congress has enacted small targeted tax reductions to encourage saving. Each of this year's proposals for additional tax relief on savings is an extension of a change embodied in the Taxpayer Relief Act of 1997:

  They won't eliminate the double or even treble taxation of savings inherent in the tax code, but they will have the effect, in aggregate, of moving the tax code toward a greater neutrality between consumption and savings. While only fundamental tax reform can completely eliminate the preferences for consumption over savings, the proposed incremental changes represent small but positive steps toward full neutrality of the tax code between consumption and saving.
- Ms. Hintz concludes that an across-the-board reduction in marginal tax rate represents probably the best use of the limited surplus if the objective is economically sound tax relief. Reductions in rates are simple to administer and easy for taxpayers to understand. Marginal rate reduction can easily be adjusted to achieve specific amounts of tax relief. Furthermore, says Ms. Hintz, across-the-board reductions in marginal tax rates would achieve several objectives at once: They would simultaneously reduce the tax burden on all taxpayers, married or not, and minimize the distortions due to the multiple taxation of savings that reduce incentives to saves and slow economic growth. If the surplus can be used for tax cuts, the broad-based relief embodied in a reduction in marginal tax rates should be given careful consideration.

One Surplus Option: Reducing Marginal Tax Rates
15% Bracket Breakpoints: Current Law v. Better Bracket Act



Source: Tax Foundation.

Restructuring and Reforming the Internal Revenue Service

By Senator Daniel Patrick Moynihan (D-N.Y.)

Following are excerpts from a Senate floor statement in early May by Senator Moynihan:

As illustrated by two rounds of hearings held by the Senate Finance Committee on Internal Revenue Service reform, there is much room for improvement at the IRS. There is much room for improvement in almost any of our government agencies, but few, other than the Social Security Administration, so directly affect the citizenry, and none other has the capacity to be punitive, to extract resources, to impose fines. There is no other agency such as this. It is extraordinary, the fact that we have paid so little attention to the management of the Service.

The Internal Revenue Service was created in 1862 in the administration of President Lincoln, at the time when an income tax was established to help finance the Civil War. President Lincoln signed the Civil War Income Tax Act into law July 1, 1862. However, it was not until last September, nearly a century and a half later, that the full Finance Committee exercised its oversight jurisdiction, and no credit can be too great to be given the new Chairman, Senator William Roth, for this effort.

It is our duty to know what is going on in this large public agency. It has more than 100,000 employees. In 1997, it collected $1.5 trillion and processed 210 million tax returns. We get used to these numbers, but to give a sense of dimension, 1 billion minutes ago, Julius Caesar ruled the Roman Empire. If that is what 1 billion minutes is, think what 1.5 trillion minutes would be.

Some, mind you, contend that the IRS is out of control and somehow should be abolished. In truth, we simply need to get it under control and shaped in the mode of modern management.

Last November, the Senate took an important first step to getting the agency in such a working mode by unanimously confirming Charles 0. Rossoti as Commissioner of Internal Revenue. We have previously, for generations, had tax lawyers as the Commissioners. They were superb tax lawyers, gifted and committed, but not necessarily managers for the management problem that needed to be addressed. And particularly not technologies. The Service had a huge problem bringing itself along into the computer age. Vast amounts have been spent with systems that do not interact well. And now, of course, we have the Year 2000 problem, which all agencies of government face.

> *Few agencies so directly affect the citizenry, and none other has the capacity to be punitive, to extract resources, to impose fines. There is no other agency such as this. It is extraordinary, the fact that we have paid so little attention to the management of the Service.*

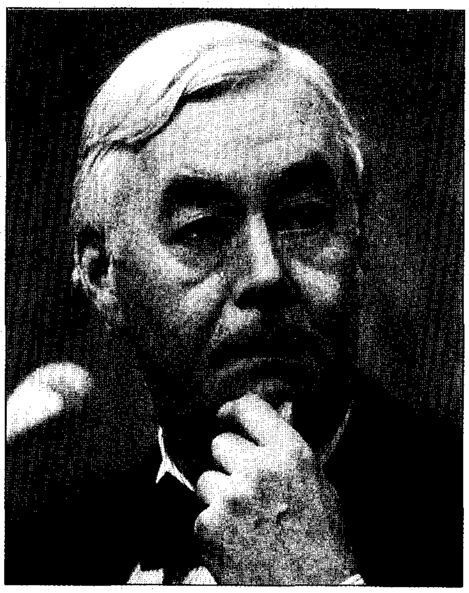
Commissioner Rossotti has already made a visible difference. He has put in motion a plan to modernize the agency by reorganizing according to type of taxpayer, such as the individual payer, the small business, the large corporation, or the exempt organization, of which there are so many, rather than according to the simple organization of regional offices that do everything.

In addition to establishing programs to improve the treatment of taxpayers, such as problem-solving days and extended telephone service, Commissioner Rossotti has done two things specifically addressed to the concerns of the Finance Committee. He has appointed former Comptroller General Charles Bowsher to conduct an independent review of the IRS internal Inspection Service. It was remarkable that the Comptroller General, after 15 years of dealing with the Congress's often unfortunate demands on the General Accounting Office, came back to public service to do this. A more qualified person you could not imagine.

Secondly, and again an achievement of some considerable measure, Mr. Rossotti has persuaded Judge William Webster, formerly the Director of the Central Intelligence Agency, and prior to that of the Federal Bureau of Investigation, to look into the activities and the operations of the Criminal Investigation Division of the Internal Revenue Service.

This is, obviously, a troubled branch of the agency. We do not associate the Internal Revenue Service with men in body armor carrying automatic weapons, breaking into offices and telling everyone to freeze, if you will. Yet, we heard testimony that could not be doubted that just such things are happening, and they need to be very carefully controlled and obviously have not been. How widespread that behavior is, we do not know. But we will learn from Judge Webster, and not a moment too soon.

The legislation before us represents a second major step. It would establish



an Internal Revenue Service oversight board consisting of six private citizens, a representative of the IRS employees' union, the Secretary of the Treasury, and the Commissioner of the IRS. The board will be responsible for certifying the strategic direction and goals of the agency, while the Commissioner will continue to manage all day-to-day operations.The Finance Committee specifically voted to include the Secretary and a union representative on the board, making the composition of that board identical to that of the House bill reported out of the Committee on Ways and Means, which passed the House of Representatives by an extraordinary vote of 426-4.

But now it should be clear in anticipation of some amendments that if this board is to have any stature within the government and with the public, the Secretary of the Treasury must be on it. That is basic management practice. As Senator John Breaux aptly stated during the Finance Committee markup, it is also far better to have the union working cooperatively on the inside rather than working in opposition on the outside.

I would also point out that the bill includes a number of provisions to create flexibility for the Commissioner in the area of personnel. In recognition of the great disparity between the salary structures in government and those in the private sector on parallel activities, the legislation provides a streamlined process by which the Commissioner can appoint up to 40 individuals designated critical technical and professional positions for up to four-year terms at an annual compensation equivalent to the pay of the Vice President, currently $175,400.

The Commissioner can go out and find this person to do this particular job and make it a four-year appointment. Persons who obviously are in the private sector will come into government at not too large a sacrifice, and for most it would be a considerable one. I do not want to use the word "sacrifice" — lachrymose, perhaps — just a large reduction in income for the kinds of persons that will be sought after, but not so large that they cannot manage the transition.

Other provisions will permit the establishment of a new performance management system focused on individual accountability and will allow for the creation of an award system to provide incentives for and recognition of individual group and organizational achievements. Additional measures call for the termination of IRS employees for violations committed in connection with the performance of their official duties.

The bill contains two provisions of special interest to this senator. It would require the staff of the Joint Committee on Taxation to provide an analysis of complexity and administrative issues associated with all pending tax legislation.

Many of the problems faced by the IRS arise from the Tax Code itself. One of the clearest visions of the National Commission on Restructuring the Internal Revenue Service was simplification of the tax law which says it is necessary to reduce taxpayer burden and facilitate improved tax administration. One has to note, regrettably perhaps, that our proposal for simplification goes on some 511 pages. This is a pattern we have gotten into which we ought to avoid.

If enacted, and this bill will be enacted it will be the 64th public law to amend the Internal Revenue Code since the great Tax Reform Act of 1986. In 1986, led by Senator Packwood, we greatly simplified the Code. We lowered tax rates, we broadened the base, we got rid of all manner of absurdities and irrational provisions in the Code....

This sort of analysis will take time to do it, but 20 years from now we may look back and think that one of the most important provisions that was contained in this measure was the report by the Joint Committee on Taxation of the complexity of a tax measure, and how well, in fact, the IRS could handle its administration. Because if we failed to simplify the Code, we failed to address the heart of this problem. Complexity contributes to taxpayer frustration, obviously, and to tax evasion, as well....

Commissioner Rossotti, in his testimony before the Finance Committee, stated that tax evasion is now at an estimated $195 billion a year. If we were to do no more than collect half the taxes now owed and deliberately not paid, our revenue situation would be profoundly changed. And that can be done, and I think Commissioner Rossotti intends to at least attempt it. We are talking about laws here. If we are a nation of laws, not only do taxpayers have rights, but they have responsibilities. Both should be pursued with energy and effectiveness....

Senator Bob Kerrey, Co-Chairman of the National Commission on Restructuring the Internal Revenue Service, will manage the legislation on our side. Senator Kerrey and Senator Charles Grassley's superb report, "A New Vision for the IRS," which was issued in June 1997, has led to the work we are doing now, which we bring to the floor with pride and with the expectation that we will be successful.

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.*

A Surprise for Taxpayers in Some "Low Tax" States

Minus the Federal Taxes, They're Actually "High Tax" States

A closer look at the Tax Foundation's 1998 analysis of total tax burdens by state contains a surprise: Many states with high overall tax burdens, relative to other states, actually rank fairly low when judged by their state and local taxes alone — and vice versa.

As the table below shows, while the total average tax rate for residents of Connecticut (39.85%) is the highest in the nation, Hawaiians have the highest average tax rate when federal taxes are stripped out. The Aloha State's state and local average tax rate (14.19%) edges out New York's (13.6%) and Wisconsin's (13.52%) for top honors in this category.

By removing federal taxes from the mix, Connecticut falls from 1st in the nation to 6th for state/local taxes. Moreover, New Jersey falls from 5th overall to 22nd in the nation, and Massachusetts drops from 6th overall to 23rd in the nation. Illinois seems to fall the farthest when federal taxes are left out — from 7th to only 32nd when state and local taxes alone are considered.

On the other hand, Mississippi, ranked No. 31 on total tax load, comes in at No. 9 when its residents are measured solely by their state and local taxes as a percentage of income. And New Mexico, ranked 20th for its total tax burden, rises to 8th when state and local taxes become the only yardstick.

The reason for the dramatic change in the fortunes of some states' residents: Federal income taxes place such a proportionately greater burden on America's affluent that when these taxes are removed from the calculation, less affluent states with relatively high state taxes, local taxes, or combined state-and-ocal taxes soar toward the top of the list.

Average State/Local and Total Tax Rates by State, 1998

	State/Local Taxes as % of Income	State/ Local Rank	Total Taxes Taxes as of Income	Total Rank
Total	11.45%	–	35.45%	–
Hawaii	14.19%	1	35.30%	17
New York	13.60%	2	37.06%	4
Wisconsin	13.52%	3	37.35%	2
Maine	13.34%	4	35.81%	13
Minnesota	13.13%	5	37.19%	3
Connecticut	12.85%	6	39.85%	1
Utah	12.70%	7	36.11%	11
New Mexico	12.38%	8	35.14%	20
Mississippi	12.34%	9	34.69%	31
California	11.99%	10	35.80%	14
Kentucky	11.94%	11	34.59%	33
Rhode Island	11.93%	12	35.89%	12
Vermont	11.92%	13	34.88%	27
Washington	11.77%	14	36.36%	8
Idaho	11.70%	15	34.99%	24
Missouri	11.66%	16	34.96%	25
Arkansas	11.63%	17	34.06%	36
Kansas	11.59%	18	35.40%	15
South Carolina	11.51%	19	35.08%	21
Georgia	11.50%	20	35.28%	18
Nebraska	11.46%	21	35.01%	23
New Jersey	11.40%	22	37.02%	5
Massachusetts	11.39%	23	36.71%	6
Ohio	11.36%	24	35.06%	22
Iowa	11.31%	25	33.65%	39
Nevada	11.27%	26	36.23%	10
Oregon	11.25%	27	34.76%	30
Maryland	11.12%	28	35.20%	19
Delaware	11.11%	29	34.06%	37
Indiana	11.04%	30	34.84%	29
Arizona	11.01%	31	34.85%	28
Illinois	11.00%	32	36.41%	7
Michigan	10.99%	33	36.27%	9
West Virginia	10.81%	34	33.12%	42
Colorado	10.81%	35	34.90%	26
North Carolina	10.77%	36	34.02%	38
Pennsylvania	10.74%	37	34.65%	32
Montana	10.70%	38	33.46%	40
Oklahoma	10.67%	39	32.28%	48
North Dakota	10.67%	40	32.69%	47
Florida	10.65%	41	35.32%	16
South Dakota	10.62%	42	32.91%	44
Texas	10.52%	43	34.19%	34
Virginia	10.32%	44	34.07%	35
Louisiana	10.20%	45	32.72%	46
Alabama	9.47%	46	32.94%	43
Tennessee	8.61%	47	32.73%	45
Wyoming	7.89%	48	33.23%	41
New Hampshire	6.52%	49	31.37%	50
Alaska	6.09%	50	31.74%	49
District of Col.	18.10%	–	41.04%	–

Source: Tax Foundation.

FOUNDATION MESSAGE

Politics by the Numbers

J.D. Foster, Ph.D.
Executive Director &
Chief Economist
Tax Foundation

Let's start with some basic data: 20.2 percent, $1.7 trillion, $390 billion, May 10, $200 billion, and $100 billion.

What do these numbers have in common? They all express in one way or another the simple fact that the federal government is getting bigger and bigger, with no relief in sight.

Federal taxes now represent about 20.2 percent of Gross Domestic Product. That is up from 17.8 percent when President Clinton took office and compares with the previous peek of 18.7 percent that occurred in 1987.

Correspondingly, Tax Freedom Day for 1998 is estimated to have been May 10, up 8 days since President Clinton took office, and six days later than in 1981, the year before Ronald Reagan's tax cuts began to take effect.

According to the Congressional Budget Office's April assessment federal receipts are projected to reach $1,710 billion in 1998, up from $1,579 billion in 1997. Indeed, receipts are coming in so fast that CBO's April projection for 1988 almost equals its projection of last January for total receipts in 1999.

Based on CBO's April figures, the total budget surplus over 1998 through 2003 should run about $390 billion, assuming no change in policies that the economy performs in the outyears as CBO assumed back in January.

Now, I know it's easy to miss the big picture when bivouacked here in our nation's capitol. And it's easy to overlook some details when alternately engrossed in economic theory and running a small business. But have I missed something here? Just exactly when did we decide as a nation that the tax burden should rise unchecked?

In the last presidential election, the two contestants were talking about tax cuts. So it must have happened since the 1996 election. But I have neither heard nor read of any great debate in Congress about how government should be allowed to grow faster than the weeds in my rain-soaked back yard.

> ***For all their public posturing to the contrary, it's clear both political parties agree the course we're on — bigger government and higher taxes — is the right one.***

Was there a national referendum that I missed?

We are living through a fundamental-though-gradual shift in the role of government in society as measured by the most objective gauge possible — total taxes and spending. And it is happening mostly by default, without great debate and without action taken by our representatives affirming that this is the path we want to take.

However, if we look for clues as to whether these changes reflect the national will, we have three good ones now in Congress. To start, two bills heading for completion reveal the underlying bipartisan mood of this Congress — the highway legislation and the tobacco legislation.

The $200 billion federal highway bill represents an enormous increase in infrastructure spending. There is near universal agreement that we need to make a major investment in the repair and modernization of our infrastructure, so perhaps every penny of this bill is warranted. Still, this bill provides a clue about Washington's mindset.

Then there is the tobacco legislation. The final numbers are as yet undetermined, but the bill is likely to raise about $100 billion over the next five years. At the moment, it appears that all of this money will be used to increase either federal, state, or local spending — another clue.

The third clue was a poorly received attempt by Budget Committee Chairman Kasich (R-Ohio) to reduce federal spending by $100 billion over five years. Chairman Kasich is a Republican and Republicans are supposed to be for smaller, less intrusive government. So it would seem obvious that he would offer guidance on how to cut spending. And so he offered his guidance, to the tune of about $20 billion a year, or about 1 percent of total spending. Kasich was, of course, strongly attacked by the avowed fans of government. But he was also attacked by a great many members, including the leaders, of his own party in the House and Senate. Not for timidly offering up a paltry effort, but for going too far!

Let's put the clues together now and see what we have. We have a huge expansion in infrastructure spending, we have a large tax increase funding more spending, and we have a Budget Committee Chairman denounced by his own party for suggesting that spending could be cut 1 percent.

All this is happening against a backdrop of rising taxes and a rapidly mounting budget surplus.

And so we see why there's been no national referendum on whether government should be growing. There's no need for one. For all their public posturing to the contrary, it's clear that both political parties fundamentally agree the course we're on — bigger government and higher taxes — is the right one. In a prior State of the Union speech President Clinton declared the era of big government is over. To which I say, "Big government is dead! Long live big government!"

U.S. Taxes Climb to $2.7 Trillion in '98

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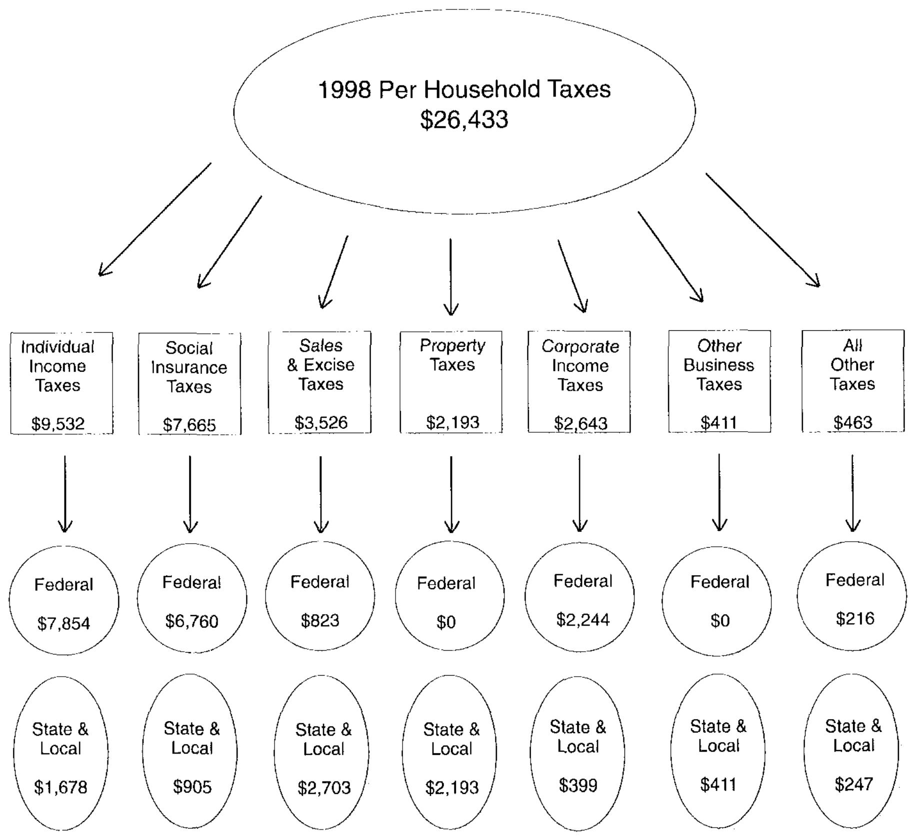
Tax Foundation
(202) 783-2760 Tel
(202) 942-7675 Fax
www.taxfoundation.org
taxfnd@intr.net

Total tax collections in the U.S. are expected to equal $2.667 trillion in 1998, according to an analysis by the Tax Foundation. To put this figure into perspective, federal, state, and local governments will collect an average of $26,434 in taxes for every household in the country.

The analysis by Foundation Economist Patrick Fleenor showed that the federal government is expected to collect 67.7 percent of this total, or $17,897. State and local governments will collect another $8,536.

The chart below illustrates that these funds stem from a variety of sources. Individual income taxes and social insurance taxes, are the two largest sources of revenue. Individual income taxes will represent 36.1 percent of all tax receipts, or $9,532. Social insurance taxes, which fund programs such as Social Security and Medicare, will provide governments with 29.0 percent of total tax revenue, or $7,665.



TAX FOUNDATION
Since 1937
1250 H Street, NW Suite 750
Washington, DC 20005-3908