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New Congress to Ponder More Tax Cuts

President Bush Proposes Accelerating 2001's Tax Cut and Exempting Dividend Income

By videotape, President Bush congratulated the Tax Foundation on its 65th anniversary. See page 14.

President Bush has unveiled his Fiscal Year 2004 budget, proposing a new round of changes to the tax code with the goal of taking pressure off taxpayers and stimulating job creation.

The plan includes four provisions that merely accelerate into 2003 some changes that have already passed into law as part of the so-called Bush tax cut in 2001. It also has several new changes, including two major tax provisions and two spending provisions designed to address unemployment. The four accelerations are:

- ♦ Make all the income tax rate reductions from the 2001 tax law effective in 2003 instead of in 2004 and 2006;
- ♦ Reduce the marriage penalty this year, instead of in 2009;
- ♦ Raise the child tax credit from $600 to $1,000 per child this year, instead of in 2010;
- ♦ Raise the amount of income subject to the new, lowest tax bracket of 10 percent from $6,000 to $7,000 for individuals, and from $12,000 to $14,000 for couples, instead of in 2008.

Four of the new provisions are:

See New Tax Cuts *on page 2*

After the President announced his new tax plan on January 7, Time Magazine *asked Tax Foundation Chief Economist John Barry to calculate potential savings for a variety of taxpayers. This table appeared in* Time *on January 12.*

Who Would Get the Biggest Tax Break?

	Single Filer			Married Couple w/ No Children			Married Couple w/ Two Children		
Total Income	Tax under Current Law	Tax under Bush Plan	Tax Savings	Tax under Current Law	Tax under Bush Plan	Tax Savings	Tax under Current Law	Tax under Bush Plan	Tax Savings
$ 40,000	$ 4,986	$ 4,684	6.1%	$ 3,293	$ 2,849	13.5%	$ 1,178	$ 28	97.6%
$ 70,000	$ 13,086	$ 11,603	11.3%	$ 8,813	$ 7,248	17.8%	$ 5,678	$ 4,507	20.6%
$ 150,000	$ 31,094	$ 26,941	13.4%	$ 26,126	$ 21,838	16.4%	$ 24,332	$ 21,592	11.3%
$ 300,000	$ 77,817	$ 64,768	16.8%	$ 71,741	$ 61,640	14.1%	$ 71,186	$ 64,244	9.8%

Source: Tax Foundation calculations based on IRS data.
Notes: In these examples, those earning $40,000 or $70,000 took the standard deduction. Those earning more were assumed to itemize deductions, and average deductions for each income level were calculated from IRS data.

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Building a Constituency for Tax Simplification

Rep. Amo Houghton (R-NY), Chairman, Oversight Subcommittee, Committee on Ways and Means

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New Tax Cuts *from page 1*

♦ Eliminate the double tax on corporate earnings, primarily by exempting dividend income from individual income tax;

♦ Raise from $25,000 to $75,000 the amount of equipment purchases that small businesses can write off as expenses;

♦ Extend unemployment benefits that expired on December 28th and make them retroactive so that people who lost benefits in December will receive them in full; and

♦ Create Personal Re-employment Accounts that would give unemployed workers up to $3,000 to use for job training, child care, transportation, moving costs, or other job-hunting expenses.

The President asked that all the provisions be made effective retroactive to January 1, 2003. The President is also asking that these changes be a permanent part of tax law. For these proposals to become permanent, rather than temporary, with an expiration date ten years hence, as was the case with the 2001 tax cut, the President will need solid support in the Senate, including at least 9 Democrats. Making permanent changes to the federal revenue stream requires 60 votes in the Senate to waive a point of order (see article on page 6).

Table 1: Income Tax Rate Reductions, Current Law vs. New "Acceleration" Proposal

Current Law: Gradually Lowering Income Tax Rates

Calendar Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2002–2003	27%	30%	35%	38.6%
2004–2005	26%	29%	34%	37.6%
2006–2010	25%	28%	33%	35%

Source: Joint Committee on Taxation.

New Bush "Acceleration" Proposal

Calendar Year	27% rate reduced to:	30% rate reduced to:	35% rate reduced to:	38.6% rate reduced to:
2003–2010	25%	28%	33%	35%

Source: Department of the Treasury.

Table 2: Raising the Child Credit, Current Law vs. New "Acceleration" Proposal

Current Law: Gradually Raising the Child Credit

Calendar Year	Amount Each Tax Return Can Subtract from Taxes Due, Per Dependent Child
2002–2004	$ 600
2005–2008	$ 700
2009	$ 800
2010	$ 1,000

Source: Joint Committee on Taxation.

New Bush "Acceleration" Proposal

Calendar Year	Amount Each Tax Return Can Subtract from Taxes Due, Per Dependent Child
2003–2010	$ 1,000

Source: Department of the Treasury.

Faster Implementation of Lower Income Tax Rates

Most of the rate cuts passed in 2001 were scheduled to phase in slowly throughout this decade. Those phase-in schedules in current law, whose main purpose was to reduce the size of the tax cut, are displayed in Table 1. President Bush is now proposing to make all the cuts that would take place in 2004 and 2006 effective in 2003.

Faster Increase in the Child Credit

In 1997, Ways and Means Chairman Bill Archer (R-TX) ushered into law the only significant tax cut to become law during the Clinton years. Its largest provision was a new income tax credit of $500 per child.

As part of his tax cut proposal in 2001, President Bush asked for an increase in the child credit to $1,000, and it was enacted. Like the rate cuts, the change to the child credit was planned to take effect in stages to make the overall tax cut smaller. Now President Bush is asking Congress to accelerate into 2003 the $1,000 child credit that will eventually become law in 2010 anyway (see Table 2).

Under both current law and the new Bush proposal, higher-income taxpayers get no benefit from the child tax credit. When the child credit was first debated in 1996–97, Rep. Christopher Shays (R-CT) protested that higher-income taxpayers did not need the credit. He prevailed and the law was written so that the benefits are phased out for single filers with adjusted gross incomes (AGI) over $75,000 and joint filers with AGIs over $110,000.

Faster Marriage Penalty Relief

Under current law, two-income married couples with similar incomes often pay higher income taxes than they would if they were unmarried, filing single tax returns (see example below). Many couples planning a November or December wedding have even noticed that if they wait until after New Year, they'll save enough money in taxes to pay for their honeymoon. One such couple was David and Angela Boyter.

The Boyters generated national publicity and media attention (as well as some negative attention from the

IRS) in the 1970s by marrying and divorcing three times in order to avoid the marriage penalty. After each divorce they used the money they saved in taxes to pay for a Caribbean vacation. After the third divorce they announced plans to remain together but unmarried until the marriage penalty was eliminated.

Eliminating the marriage penalty completely is harder than it sounds because it is not an actual additional tax. More than 60 provisions of the tax code vary with marital status, some causing higher taxes and some lower. But the two provisions most often responsible are the standard deduction and the width of the 15-percent tax bracket. These two problems were fixed as part of President Bush's 2001 tax cut package, by

♦ Raising the standard deduction for couples to twice that of the standard deduction for a single filer;

♦ Widening the 15-percent tax bracket for married couples so it includes twice the income of the single filers' 15-percent bracket; and

♦ Adjusting the amounts that couples can earn and still qualify for the Earned Income Tax Credit.

However, the fix was postponed until later in the decade to keep the size of tax cut lower. Table 3 shows this schedule to phase in, and how President Bush is now asking Congress to make the fix immediate.

Table 3: Marriage Penalty Relief, Current Law vs. New Proposal

Current Law: Gradually Raising the Standard Deduction for Couples*

Calendar Year	Standard Deduction for Couples as a Percentage** of Standard Deduction for Singles
2002–2004	167%
2005	174%
2006	184%
2007	187%
2008	190%
2009–2010	200%

New Bush "Acceleration" Proposal for Standard Deduction

Calendar Year	Standard Deduction for Couples as a Percentage of Standard Deduction for Singles**
2003–2010	200%

* Note: Couples are assumed to file a joint return.
** Note: The actual dollar amount of the standard deduction is calculated by the IRS at the end of each year to account for inflation, so the increase in the standard deduction for couples is presented as a percentage of the standard deduction for singles.

Current Law: Gradually Raising the Top End of the 15-Percent Rate Bracket for Couples*

Calendar Year	Top End of the 15-Percent Rate Bracket for Couples as a Percentage** of Top End for Singles
2002–2004	167%
2005	174%
2006	184%
2007	187%
2008	190%
2009–2010	200%

New Bush "Acceleration" Proposal for 15-Percent Bracket

Calendar Year	Top End of the 15-Percent Rate Bracket for Couples as a Percentage of Top End for Singles
2003–2010	200%

* Note: Couples are assumed to file a joint return.
** Note: The actual dollar amounts that mark the end of each tax bracket are calculated by the IRS at the end of each year to account for inflation, so the rising top end of the bracket for couples is presented as a percentage of the top end of the bracket for singles.

Table 4: Example of a Marriage Penalty under Current Law

2003

	Paul	Lisa	Filing as a Couple
Income	$40,000	$40,000	$80,000
Less Personal Exemptions	($3,050)	($3,050)	($6,100)
Less Standard Deduction	($4,800)	($4,800)	($8,050)
Equals Taxable Income	$32,150	$32,150	$65,850
Amt. Taxed at 10%	$6,000	$6,000	$12,000
Amt. Taxed at 15%	$22,400	$22,400	$35,450
Amt. Taxed at 27%	$3,750	$3,750	$18,400
Total Tax Liability	$4,972	$4,972	$11,485
Marriage Penalty			$1,541

Paul and Lisa's Marriage Penalty

The marriage penalty can best be illustrated by two hypothetical individuals earning the same amount and who, while planning to marry, calculate how much more they'll pay in taxes as a couple than they would if they stayed single (see Table 4).

There are two reasons for their $1,541 penalty. First, they find that the standard deduction for joint filers is not twice that of a single filer. Instead of deducting $4,800 each as single filers, they'll deduct $8,050 together, losing $1,550 of the combined standard deductions.

Second, as a couple, Paul and Lisa have a larger percentage of their taxable income taxed at a higher rate. This is because the top of the 15 percent tax bracket is $28,400 for single filers but only $47,450 for couples filing jointly.

No Perfect Solution

Because the federal income tax code is "progressive," (tax rates rise

See New Tax Cuts *on page 4*

New Tax Cuts

from page 3

with income), it can never be even-handed for all taxpayers before and after marriage. The two conflicting principles are: neutrality with regard to marriage (two single filers should pay the same amount before marrying as after); and equal treatment of couples (two couples with the same income should pay the same amount of tax, regardless of each couple's income split). Although the President's marriage penalty relief greatly reduces the number of people who pay more when married, only a greatly simplified tax code could avoid the problem entirely.

Excluding Dividend Income from Taxation

A major component of President Bush's new proposal is a tax break on dividends. In years past, the tax treatment of dividends has varied from fully exempt to partially exempt to fully taxable, and they've been fully taxable since 1985.

Dividend income is the victim of a double tax that economists across the political spectrum have long advocated fixing. That can be done by eliminating the individual tax on dividend income — as President Bush suggests — or by allowing companies to deduct dividends as an expense (like interest), thereby eliminating the tax on the corporate side. As long as dividend income is taxed at both ends, companies have little incentive to issue dividends and every incentive to hold profits in an attempt to raise share prices.

Who Benefits from Dividend Exclusion?

Some press reports have conveyed the mistaken notion that few people receive taxable dividends. According to the most recent IRS data, 34.1 million tax returns declared some dividend income in 2000, representing 71.0 million people. That is 26.4 percent of the nation who declared $147.0 billion in dividend income, or 2.3 percent of all income reported by all taxpayers.

Nearly half (45.8 percent) earned less than $50,000 when income is measured as adjusted gross income which includes dividends. If we count just wages and salaries, 63.8 percent of taxpayers claiming dividends earned less than $50,000.

Of the 34.1 million tax returns with dividend income, 13.1 million also had some self-employment or

Table 5: Taxable Dividend Income by State

	2000			2003e	
	Number of returns w/ dividend income	Percentage of all returns w/ dividend income	Total dividend income ($ thousands)	Estimated tax relief from dividend tax exclusion ($ thousands)	Savings per Tax Return w/ dividend income
United States	34,099,783	26.2%	$ 144,673,140	$ 20,233,057	$ 593
Alabama	344,337	18.1%	$ 1,301,348	$ 152,886	$ 444
Alaska	93,502	28.4	255,374	33,965	363
Arizona	562,837	26.1	2,422,650	312,540	555
Arkansas	209,751	18.8	1,040,068	119,926	572
California	3,909,981	26.3	18,760,934	2,859,955	731
Colorado	636,620	30.4%	$ 2,505,211	$ 364,286	$ 572
Connecticut	622,976	37.3	3,184,709	552,192	886
Delaware	109,609	29.0	378,169	50,998	465
Florida	1,973,470	26.3	11,892,958	1,738,382	881
Georgia	800,241	22.0	3,282,934	433,018	541
Hawaii	161,773	28.3%	$ 171,333	$ 20,128	$ 124
Idaho	134,351	24.0	463,083	53,955	402
Illinois	1,701,830	29.4	7,146,114	1,050,112	617
Indiana	643,443	22.7	2,147,396	265,375	412
Iowa	397,577	29.4	1,105,279	127,000	319
Kansas	339,549	27.8%	$ 1,204,027	$ 159,800	$ 471
Kentucky	346,700	19.8	1,276,911	147,949	427
Louisiana	345,541	18.4	1,251,115	150,731	436
Maine	152,160	25.1	596,961	69,458	456
Maryland	733,391	28.6	3,028,570	407,994	556
Massachusetts	1,008,963	32.4%	$ 4,798,545	$ 802,751	$ 796
Michigan	1,262,007	27.3	4,691,541	616,549	489
Minnesota	763,582	32.0	2,387,314	316,617	415
Mississippi	173,473	14.8	590,616	63,324	365
Missouri	665,460	25.9	2,433,067	308,133	463
Montana	124,028	29.2%	$ 384,355	$ 42,061	$ 339
Nebraska	232,926	28.8	700,433	85,559	367
Nevada	197,671	20.7	1,227,916	177,455	898
New Hampshire	191,720	30.0	824,461	122,117	637
New Jersey	1,453,494	35.7	5,971,989	943,644	649
New Mexico	140,281	19.3%	$ 483,089	$ 50,021	$ 357
New York	2,610,955	30.4	12,347,427	1,895,482	726
North Carolina	835,750	23.0	3,208,042	392,890	470
North Dakota	83,308	27.5	190,172	21,259	255
Ohio	1,438,884	25.8	5,168,271	636,376	442
Oklahoma	279,477	19.1%	$ 906,470	$ 106,374	$ 381
Oregon	428,656	27.4	1,643,203	204,588	477
Pennsylvania	1,763,134	30.4	7,146,042	959,074	544
Rhode Island	135,533	27.4	493,346	63,974	472
South Carolina	355,681	19.7	1,394,123	158,838	447
South Dakota	94,155	26.5%	$ 276,372	$ 34,278	$ 364
Tennessee	474,633	18.5	1,834,325	233,708	492
Texas	1,809,168	20.0	7,937,488	1,157,181	640
Utah	193,861	20.6	651,022	72,226	373
Vermont	89,460	29.9	391,860	47,600	532
Virginia	958,021	28.7%	$ 3,768,585	$ 516,530	$ 539
Washington	790,470	28.5	3,431,490	521,340	660
West Virginia	138,893	18.5	469,918	51,164	368
Wisconsin	800,505	30.8	2,502,234	307,761	384
Wyoming	64,822	27.6	385,764	57,337	885
Dist. of Columbia	67,551	24.2%	$ 525,235	$ 82,469	$ 1,221

Source: 2000 data from Dept. of the Treasury; 2003 estimates by Tax Foundation.

small business income reported.

Taxable Dividends Vary Dramatically by State

The percentage of taxpayers claiming dividend income varies greatly by state. Connecticut and New Jersey had the highest percentages of taxpayers claiming taxable dividends in 2000: 37.3 percent and 35.7 percent respectively. Other states with nearly one-third of their taxpayers claiming dividend income were Colorado (30.4%), Massachusetts (32.4%), Minnesota (32.0%), New Hampshire (30.0%), New York (30.4%), Pennsylvania (30.4%), and Wisconsin (30.8%). See Table 5 for more details.

States with large populations naturally lead in total dividend income: Californians claimed $18.7 billion in 2000. New York was second with $12.3 billion, followed closely by Florida with $11.9 billion. Illinois and New Jersey rounded out the top five with taxpayers claiming $7.1 billion and $5.9 billion in dividends respectively.

Based upon these 2000 returns, Tax Foundation economists have estimated how much each state's taxpayers would save if dividends were exempted from taxation as the President proposes (see Table 5). If dividend income in 2003 matched the 2000 level, taxpayers would save a total of $20.2 billion nationwide — an average of $593 among those tax returns.

States that would receive the most tax relief per taxpayer with dividend income include Nevada ($898), Connecticut ($886), Wyoming ($885), and Florida ($881).

Nearly half of all tax returns with dividend income, 45.8 percent, earned less than $50,000, including the dividends. If we count just wages and salaries, 63.8 percent of taxpayers claiming dividends earned less than $50,000.

Addressing Unemployment

Few economic indicators are of more concern to Americans than unemployment statistics. Each month, the Bureau of Labor Statistics (BLS) randomly surveys 60,000 individuals around the nation. If respondents say they are unemployed and seeking work, they are counted as unemployed.

During December 2002, the survey showed unemployment to be 6.0 percent, slightly below the average since 1970: 6.3 percent.

Unemployment Compensation

Unemployment Insurance (UI) was first enacted in 1935 during the Great Depression when unemployment rates reached 25 percent.

UI is now run as a combined federal/state program, so the benefits paid to the unemployed and the taxes that fund these payments vary by state. Most states pay benefits for six months after a one-week waiting period.

The Economics of Unemployment Compensation

A basic tenet of economics is that when an activity is subsidized, people do more of it. Economists have found that unemployment insurance is no exception to this rule — it increases unemployment by prompting the unemployed to prolong their job search. The closer that unemployment compensation comes to matching the unemployed person's former wage, the longer the unemployment will last.

Policymakers have long sought to reduce the adverse effects of unemployment compensation while still assisting people who lose jobs. Congress had begun partial income taxation of UI benefits in 1979, but the 1986 Tax Reform Act took it further, taxing unemployment benefits just like other income.

If that approach seems like using a stick to diminish unemployment compensation's perverse anti-work effect, President Bush has now offered a carrot with his new "re-employemnt accounts.

Personal Re-Employment Accounts

President's Bush proposes that when a person is unemployed, he be given a $3,000 "re-employment account." It could be used for job-hunting expenses, and if the person finds work within 13 weeks, he could keep the remainder — essentially a cash bonus for getting back into the workforce.

Facts on Unemployment

Unemployment is not higher than usual, but President Bush's new tax plan includes a 3-month extension of compensation for people who have used up 6 months of benefits.

Facts that make unemployment rates seem MORE worrisome:

♦ Unemployed people can become "discouraged," the official term for people who have stopped looking. The "discouraged" are not counted.

♦ Sometimes two apparently short periods of unemployment are actually one long one separated into two by a period "out of the workforce," i.e., the person stopped looking.

Facts that make unemployment rates seem LESS worrisome:

♦ Unemployment averaged 6.2% in the 1970s, 7.3% in the 1980s, and 5.8% in the 1990s, so the current rate of 6.0% is not unusual.

♦ Approximately 17 percent of the unemployed are teenagers, and presumably not breadwinners.

♦ The average duration of a spell of unemployment has hovered between 16 and 18 weeks in recent months, shorter than the typical benefit period of 26 weeks. The median spell of unemployment is even shorter, varying between 8 and 10 weeks.

♦ Roughly 10 percent of the unemployed are people applying for benefits with no intention of working.

New Report Shows the Impact on Typical Families If Tax Cuts Accelerate, Then Expire

Four-Person Family's Tax Burden May Be Much Lighter Through 2010 But Much Heavier Thereafter

A new *Tax Foundation Special Report* by Chief Economist John S. Barry examines two potential turning points in the income tax liability of the typical family of four (see Publication Summary).

One is the potential "acceleration" of the 2001 tax cut, currently proposed by President Bush, and the other is the "expiration" of that same legislation, which is already set in law to occur at the end of 2010.

"Acceleration" refers to the possibility that the Congress will agree to President's Bush's new proposal to make effective in 2003 the rate cuts, credit increases, and bracket adjustments that are currently set in law to take place later in the decade, mostly between 2006 and 2010. (See tables in lead article for details.)

"Expiration" refers to the fact that the entire 2001 tax cut is set in law to expire on December 31, 2010, returning all rates, brackets and credits to what they were at the beginning of 2001.

How Will Faster Tax Cuts Affect the Typical Family?

Because median family income varies by state, accelerated tax cuts will benefit some more than others. Measured as a percentage of federal income taxes due, the tax bill of a typical family of four in Arkansas will drop the most (49%). Similar families in Montana, West Virginia, Mississippi, New Mexico and Louisiana will also save more than 40 percent in 2003. Families in high-income states would get a bigger tax cut in dollars but smaller as a percentage of their tax liabilities (see table on page 7).

Why Will the Tax Cut Expire?

In the 1980s, the U.S. Senate passed a rule to protect federal revenue. Named after Sen. Robert Byrd (D-WV), the so-called "Byrd Rule" gives any senator the right to block proposed legislation that permanently changes the federal revenue stream. Since 60 votes are required to waive a point of order, the Bush tax cut in 2001 ended up as a 10-year temporary tax cut that will expire at the end of 2010, returning all the income tax rates and deductions to what they were before it passed.

The House of Representatives has tried to make the cuts permanent, but Democratic Leader Sen. Tom Daschle has vowed never to bring up the permanent tax cut.

The major provisions whose expiration would dramatically affect average American families are the same ones that President Bush wants accelerated in 2003: the new 10-percent rate bracket, the wider 15-percent bracket; the bigger standard deduction; the drop in the 28-percent rate to 25 percent; and especially the increase in the per-child tax credit to $1,000.

If Congress and the President do not act to make the 2001 tax cut permanent, a typical family of four earning the median family income can expect its federal income tax bill to increase by $2,072 between 2010 and 2011, a 39.3 percent increase (see table). Families with more than two children will experience an even greater increase in their taxes between 2010 and 2011.

Just as the acceleration proposal will give a higher percentage tax cut to median-income families in several lower-income states, so the expiration

Publication Summary

General: Tax Foundation Special Report No. 119; ISSN 1527-0408; 8 pp.; $10 or $50/yr. for 6 issues on varied topics in public finance

Title: The Effect of Accelerating Scheduled Tax Cuts and Temporary Tax Relief on a Typical American Family of Four

Author: John S. Barry

Date: January 2003

Subject: Shows the effect on a family of four of President Bush's proposal to move up the effective date of tax cuts, then shows the effect of having those cuts expire on December 31, 2010, as they are currently set in law to do.

Tables: Tax Relief Offered by President Bush's "Acceleration" Proposal for a Family of Four Earning the Median Income, by State; Tax Relief Offered under the Bush Proposal for Families of Four with Various Incomes, by State, Calendar Year 2003; How a Typical Family of Four's Taxes Will Change in Each State if the 2001 Tax Cut is Allowed to Expire after 2010; Typical Allocation of Spending by a Typical Family of Four Earning the Median Income of $66,619, Calendar Year 2003

How a Typical Family of Four's Taxes Will Change When the 2001 Tax Cut Expires After 2010

	2002	2010	2011	2010–2011 Absolute Change	2010–2011 Percentage Change
Adjusted gross income	$65,058	$79,189	$81,169	+ $1,980	+ 2.5%
Standard deduction	$7,850	$11,281	$9,656	– $1,625	– 14.4%
Total personal exemptions	$12,000	$14,488	$14,850	+ $362	+ 2.5%
Taxable income	$45,208	$53,420	$56,664	+ $3,244	+ 6.1%
Tax due before credits	$6,181	$7,278	$8,500	+ $1,222	+ 16.0%
Total child tax credits	$1,200	$2,000	$1,000	– $1,000	– 50.0%
Total income taxes due	$4,981	$5,278	$7,500	+ $2,222	+ 42.1%
Effective tax rate (total fed. inc. taxes due divided by inc.)	7.7%	6.7%	9.2%	+ 2.6%	+ 38.6%

Assumptions: Current law; family takes the standard deduction and claims no childcare credits.

of the tax cut in 2010 will hit those same states harder. Measured as a percentage of federal income taxes due, the tax bill of a typical family of four in Arkansas will jump 112 percent between 2010 and 2011. Median-income families of four in Louisiana, Mississippi, Montana, New Mexico and West Virginia will all see their federal income taxes rise more than 80 percent that year unless the expiration is averted.

Tax Relief Offered by President Bush's "Acceleration" Proposal for a Typical Family of Four Earning the Median Income in Each State

	Median Adjusted Gross Income (2003)	Tax Due under Current Law (2003)	Tax Due If Tax Cut Accelerated (2003)	Tax Cut If Accelerated (2003)	Percentage Tax Cut If Accelerated (2003)	Long–Term Tax Cut If Accelerated (2003–2010)	Percentage Long–Term Tax Cut If Accelerated (2003–2010)
United States	$ 66,619	$ 5,170	$ 4,038	– $ 1,133	– 22%	– $ 6,225	– 14%
Alabama	$ 55,082	$ 3,440	$ 2,307	– $ 1,133	– 33%	– $ 6,225	– 22%
* Alaska	71,593	6,396	4,784	– 1,612	– 25	– 7,162	– 14
Arizona	59,591	4,116	2,984	– 1,133	– 28	– 6,225	– 18
Arkansas	47,680	2,329	1,197	– 1,133	– 49	– 6,225	– 34
* California	67,666	5,335	4,195	– 1,140	– 21	– 6,243	– 14
Colorado	$ 71,325	$ 6,323	$ 4,744	– $ 1,580	– 25%	– $ 7,095	– 14%
Connecticut	88,538	10,971	8,330	– 2,641	– 24	– 10,723	– 13
* Delaware	74,255	7,114	5,183	– 1,931	– 27	– 8,111	– 15
Florida	59,257	4,066	2,934	– 1,133	– 28	– 6,225	– 19
Georgia	63,687	4,731	3,598	– 1,133	– 24	– 6,225	– 16
* Hawaii	$ 70,520	$ 6,106	$ 4,623	– $ 1,483	– 24%	– $ 6,907	– 14%
Idaho	57,513	3,804	2,672	– 1,133	– 30	– 6,225	– 20
* Illinois	72,924	6,755	4,984	– 1,771	– 26	– 7,626	– 14
Indiana	66,460	5,146	4,014	– 1,133	– 22	– 6,225	– 15
Iowa	62,008	4,479	3,346	– 1,133	– 25	– 6,225	– 17
Kansas	$ 60,791	$ 4,296	$ 3,164	– $ 1,133	– 26%	– $ 6,225	– 18%
Kentucky	54,866	3,407	2,275	– 1,133	– 33	– 6,225	– 23
Louisiana	50,705	2,783	1,651	– 1,133	– 41	– 6,225	– 28
Maine	60,151	4,200	3,068	– 1,133	– 27	– 6,225	– 18
Maryland	83,035	9,485	6,954	– 2,531	– 27	– 10,499	– 14
Massachusetts	$ 83,531	$ 9,619	$ 7,078	– $ 2,541	– 26%	– $ 10,519	– 14%
* Michigan	73,591	6,935	5,084	– 1,851	– 27	– 7,858	– 15
* Minnesota	75,532	7,459	5,375	– 2,084	– 28	– 8,694	– 15
Mississippi	49,600	2,618	1,485	– 1,133	– 43	– 6,225	– 30
Missouri	65,490	5,001	3,868	– 1,133	– 23	– 6,225	– 15
Montana	$ 49,398	$ 2,587	$ 1,455	– $ 1,133	– 44%	– $ 6,225	– 30%
Nebraska	61,065	4,337	3,205	– 1,133	– 26	– 6,225	– 17
Nevada	63,821	4,751	3,618	– 1,133	– 24	– 6,225	– 16
* New Hampshire	76,718	7,779	5,553	– 2,227	– 29	– 9,256	– 16
New Jersey	84,104	9,774	7,221	– 2,553	– 26	– 10,543	– 14
New Mexico	$ 50,653	$ 2,775	$ 1,643	– $ 1,133	– 41%	– $ 6,225	– 28%
* New York	69,073	5,715	4,406	– 1,309	– 23	– 6,570	– 14
North Carolina	61,240	4,363	3,231	– 1,133	– 26	– 6,225	– 17
North Dakota	56,890	3,711	2,578	– 1,133	– 31	– 6,225	– 21
Ohio	66,644	5,174	4,042	– 1,133	– 22	– 6,225	– 14
Oklahoma	$ 51,879	$ 2,959	$ 1,827	– $ 1,133	– 38%	– $ 6,225	– 26%
Oregon	62,430	4,542	3,410	– 1,133	– 25	– 6,225	– 17
* Pennsylvania	70,027	5,973	4,549	– 1,424	– 24	– 6,792	– 14
* Rhode Island	73,246	6,842	5,032	– 1,810	– 26	– 7,738	– 15
South Carolina	60,267	4,217	3,085	– 1,133	– 27	– 6,225	– 18
South Dakota	$ 59,042	$ 4,034	$ 2,901	– $ 1,133	– 28%	– $ 6,225	– 19%
Tennessee	58,773	3,993	2,861	– 1,133	– 28	– 6,225	– 19
Texas	57,289	3,771	2,638	– 1,133	– 30	– 6,225	– 20
Utah	61,068	4,338	3,205	– 1,133	– 26	– 6,225	– 17
Vermont	63,297	4,672	3,540	– 1,133	– 24	– 6,225	– 16
* Virginia	$ 72,856	$ 6,737	$ 4,973	– $ 1,763	– 26%	– $ 7,602	– 14%
* Washington	68,054	5,440	4,253	– 1,187	– 22	– 6,333	– 14
West Virginia	49,535	2,608	1,475	– 1,133	– 43	– 6,225	– 30
* Wisconsin	71,434	6,353	4,760	– 1,593	– 25	– 7,120	– 14
Wyoming	59,801	4,148	3,015	– 1,133	– 27	– 6,225	– 18
* District of Columbia	$ 67,880	$ 5,393	$ 4,227	– $ 1,166	– 22%	– $ 6,293	– 14%

* Typical families of four in these 16 states will see their marginal tax rate drop from 27% to 15% under this proposal.
Sources: Consumer Expenditure Survey; Tax Foundation.

Building a Constituency for Tax Simplification

by U.S. Representative Amo Houghton (R-NY)

"There is no constituency for tax simplification." — Anon.

In 1935, there were 34 lines on the equivalent of Form 1040 and instructions were two pages. Today, the tax code and regulations have grown to over 9 million words. According to the Tax Foundation, individual taxpayers spent 2.8 billion hours on income tax planning and compliance during the past year, and businesses spent an additional 2.75 billion hours. Businesses, individuals, and non-profits spent a total of 5.8 billion hours. Our tax code is a growing thicket of complexity that frustrates taxpayers and slows economic growth.

Within 10 years, ... the AMT will deprive over 35 million taxpayers of at least part of the benefit of common deductions for state income and property taxes, unreimbursed business expenses, and personal credits.

To be sure, defining income in a manner that is fair and easy to administer is inherently complex, but our tax code has become far more complicated than necessary. Pamela Olson, the Treasury Assistant Secretary for Tax Policy, put it well recently when she said that our tax system "is surely not a tax system that anyone would set out to create. . . . it is the system that has evolved over time." In many cases there is a clear answer to the question of whether a rational person would design a tax provision in the same way from a clean slate.

Rep. Amo Houghton, Republican of New York, is chairman of the House Ways and Means Committee's Subcommittee on Oversight.

For example, the Alternative Minimum Tax (AMT) was originally designed to assure that very wealthy taxpayers did not make disproportionate use of deductions and credits in a single year. Unfortunately, Congress failed to adjust the AMT exemption amount for inflation when AMT was enacted in the early 1980s. I think another mistake was to include state and local income taxes on the list of AMT-restricted deductions.

As a result, the AMT is no longer aimed at the very wealthy, and, as the value of the AMT exemption continues to erode over time, AMT will increasingly serve as a shadow tax system. This will force ordinary taxpayers to calculate their income tax not once but twice. According to the Joint Committee on Taxation, within 10 years, the AMT annually will deprive over 35 million taxpayers of at least part of the benefit of common deductions for state income and property taxes, unreimbursed business expenses, and personal credits. Millions more will be required to fill out additional pages of tax forms to determine whether AMT applies in their case, and nearly all taxpayers will have to take AMT into account in planning. Ordinary taxpayers with large families, legal judgments in their favor, incentive stock options, capital gains, and those who live in high tax states will all be required to take AMT into account. Ultimately, the benefits that Congress appears to grant through the ordinary tax system will be taken away by the AMT.

It would be one thing if Congress intended the AMT to gradually ensnare more and more middle class taxpayers, but there is no evidence that Congress intended that result. Therefore, on the first day of the 108th Congress, I introduced legislation (The Individual and Small Business Tax Simplification Act, H.R. 22) to restore Congress's intent by adjusting the AMT exemption amount for inflation since the date it was enacted and indexing the exemption in future years. The bill will also restore the deduction for state and local taxes for AMT purposes, which will end another form of double taxation.

The tax complexity faced by small business owners is equally as daunting as the complexity faced by individuals. The tax code is full of illogical rules and traps for the unwary. For example, the tax code now contains two fully-articulated pass-through entity regimes: Subchapter S (S Corporations) and Subchapter K (Partnerships). While at one time, Subchapter S provided the only avenue for prospective investors to avoid the corporate-level tax while retaining a full liability protection, the emergence and broad acceptance of limited liability companies (LLCs) have provided investors with an alternative. However, differences between the two regimes are still significant, and the wrong choice of entity can have adverse tax consequences. It is often impossible to anticipate all of the reasons why in advance.

The rationale for combining Subchapter S and Subchapter K is even stronger in a post-dividend tax environment.

Maintaining multiple separate pass-through entity regimes is expensive and unnecessarily complicated. It increases costs both for taxpayers and for the IRS. It is time to rationalize this most complex area of the Internal Revenue Code by reconciling Subchapter S and Subchapter K. My bill would combine the benefits of Subchapter S and Subchapter K of the Internal Revenue Code in a single, unified pass-through entity regime based on Subchapter K. Domestic corporations that are not publicly traded would have a new election to be treated as a partnership for federal tax purposes, and the S election would be repealed. The proposal would therefore endorse, and extend, the 1996 Check-the-Box regulations to allow state law corporations to elect partnership status. Existing S corporations would be permitted to continue as S corporations for ten years at which time they would be required to elect partnership or corporate status.

This idea is not inconsistent with the President's proposal to repeal the tax on dividends, in fact, it complements the President's proposal, because that change effectively would create a third pass-through entity regime applicable to publicly traded companies. The rationale for combining Subchapter S and Subchapter K is even stronger in a post-dividend tax environment.

Another area of the tax code that is unnecessarily complicated is the taxation of capital gains. Under present law, there are seven different capital gains rates that apply to various kinds of dispositions of property. There are special rates for taxpayers in lower tax brackets, for property held five years or more, and for gain on collectibles. Before 1986, there was one rule: 50% of capital gains were deductible. For any investor who has struggled to fill out

Schedule D of Form 1040, it will come as welcome news that the bill proposes a return to the system in place prior to 1986.

No taxpayer will pay a higher capital gains rate under this proposal. By definition, the capital gains rate that individuals pay will be no more than one-half of their marginal income tax rate. Therefore, this proposal preserves the progressivity that is accomplished by a rate structure under current law, and the maximum rate will be no more than one-half of the highest marginal income tax rate. Thus, the maximum effective capital gains rate would be 18.8% in 2004, and an individual in the 10% bracket would have a 5% capital gains rate.

Under present law, there are seven different capital gains rates, ... Before 1986, there was one rule: 50 percent of capital gains are deductible. For any investor who has struggled to fill out Schedule D of Form 1040, it will come as welcome news that the bill proposes a return to the system in place prior to 1986.

The legislation that I introduced contains many other proposals to simplify the tax code that stem from the recommendations of the Joint Committee on Taxation and the Oversight Subcommittee hearings that I have held. I plan to hold additional hearings on tax simplification during the 108th Congress to consider ways to refine this legislation and to evaluate additional simplification proposals.

Unnecessarily convoluted tax laws, such as the AMT and the tax rules applicable to small business, have a real impact on economic growth. The cost of complying with the income tax is estimated at nearly $200 billion per year, far more than the cost of compliance necessary to achieve all of the legitimate goals of our tax system. Left unaddressed, these baroque inefficiencies will reduce our standard of living far into the future. This is why it is simply inaccurate to say that there is no constituency for tax simplification. It would be the same to say there is no constituency for faster economic growth and higher standards of living.

Others point to the history of recent changes in the tax law and argue that Congress and the Administration have higher priorities than to simplify the tax code, but each change that makes the internal revenue code more complicated makes the case for tax simplification more compelling.

Even if it were not for the greater economic efficiency that would flow from simplification, there would be a constituency for simplification because it is manifestly the right thing to do. We deserve a tax system that is transparent, fair, and tough enough to resist future tinkering — a tax code that reflects our character as a nation.

The Tax Foundation invites national leaders from all perspectives to contribute columns to Tax Features*. The opinions expressed are not always those of the Tax Foundation.*

Latest IRS Income Tax Data Show Top-Earning Taxpayers Earning and Paying More

Top-Earning 25 Percent of Taxpayers Earned Two-Thirds of the Nation's Income, Paid Five Out of Every Six Dollars Collected in Income Taxes

According to preliminary data released by the IRS, the top-earning 25 percent of income tax filers (annual income over $55,225) made 67.2 percent of the nation's income in 2000 and paid 84 percent of the income taxes collected. (See Table below.)

Among that group, the top one percent dominated the statistics. Those tax filers with annual income over $313,469 made 20.8 percent of the income and paid 37.4 percent of the income taxes.

The data are available in *Tax Foundation Special Report No. 118*, titled "Who Pays the Federal Individual Income Tax," by economist David Hoffman. (See Publication Summary and our web site at www.taxfoundation.org/prtopincome.html.)

These surprisingly high fractions of income earned and taxes paid by the top one percent maintained a constant ratio over the course of the 1990s. That is, as the income share of top earners has climbed from 14.0 percent in 1990 to 20.8 percent in 2000, so has the tax share kept pace, climbing from 25.1 percent ten years earlier to 37.4 percent in 2000.

At the other end of the income spectrum, the bottom 50 percent of the nation's taxpayers earned only 13.0 percent of all income in 2000, but they paid an even smaller fraction of the federal individual income taxes collected — 3.9 percent.

The steady drop in the percentage of income tax collections paid by the bottom half of the income spectrum (see Figure 1 on page 11) does not mean that all low-income taxpayers paid less in 2000 than they did ten years before, just that their tax payments did not rise as quickly as those of high-income taxpayers. Some low-income taxpayers are definitely paying less though, and those with children will continue to pay less or nothing at all as the steadily rising child credit that was part of 2001's tax cut kicks in. (See related article on page 3.)

"Americans at the upper end of the income scale continue to bear an increasing share of the total federal individual income tax burden," observed Hoffman.

"Economic growth was still strong in 2000, and in a progressive tax system like ours, economic growth inevitably results in a steady shifting of the tax burden up the income scale."

As the table and figure show, both the top five percent of income earners (adjusted gross income over $128,336) and the top 10 percent (adjusted gross income over $92,114) are earning a greater share of the nation's income and paying a greater portion of the income taxes than they did a decade ago.

In fact, the tax load has since shifted upward so dramatically that whereas a decade earlier in 1990, approximately 55 percent of all federal income tax collections came from the top 10 percent of income earners, 2000 data show that a higher percentage than that is now being paid by just the top five percent.

Publication Summary

General: Tax Foundation Special Report No. 118; ISSN 1068-0306; 4pp.; $10 or $50/yr. for 6 issues on varied topics in public finance

Title: Who Pays the Federal Individual Income Tax?

Author: David Hoffman

Date: November 2002

Subject: Publication of the latest IRS data on the payment of individual income taxes by different segments of the income spectrum. Income and tax data presented for years 1980–2000.

Tables: Who Pays Federal Individual Income Taxes, 1990 and 2000; Shares of Adjusted Gross Income by Income Group, 1980–2000; Federal Individual Income Tax Shares by Income Group, 1980–2000

Federal Individual Income Tax Data

2000

Income Group	Number of Returns (000)	AGI ($000,000)	Income Taxes Paid ($000,000)	Group's Share of Total AGI	Group's Share of Income Taxes	Income Split Point	Average Tax Rate
All Taxpayers	128,227	$ 6,423,977	$ 980,521	100.0%	100.0%	–	15.3%
Top 1%	1,282	$ 1,336,773	$ 366,929	20.8%	37.4%	above $313,469	27.4%
Top 5%	6,411	$ 2,267,403	$ 553,670	35.3%	56.5%	above $128,336	24.4%
Top 10%	12,822	$ 2,955,386	$ 660,150	46.0%	67.3%	above $92,114	22.3%
Top 25%	32,057	$ 4,313,786	$ 823,706	67.2%	84.0%	above $55,225	19.1%
Top 50%	64,114	$ 5,589,755	$ 942,179	87.0%	96.1%	above $27,682	16.9%
Bottom 50%	64,114	$ 834,222	$ 38,342	13.0%	3.9%	below $27,682	4.6%

Source: Preliminary data, IRS

Bush Tax Plan Would Raise Number of Non-Paying Tax Filers More than 10 Percent

Almost 40 million tax returns will show nothing owed to Uncle Sam in 2003 if President Bush's new tax plan is enacted. That would be almost 27 percent of the country's tax filers.

Even if no changes are made, 35.8 million tax returns are still expected to show no tax liability. If these tax filers have had taxes withheld from their paychecks during the year, they'll get all of it back, and most will get a check because of the Earned Income Credit.

The Bush plan to accelerate the provisions of the 2001 tax cut would remove an additional 3.8 million tax filers from the ranks of those who pay. Three million of those are families whose tax liability would be wiped out by the higher per-child tax credit ($1,000 in 2003 instead of in 2010). Because of the many dependent children on these returns, the number of people represented by returns with zero tax liability will rise more than 12 million — from 69.6 to 82.0 million.

Cutting Income Taxes for People Who Don't Owe Any?

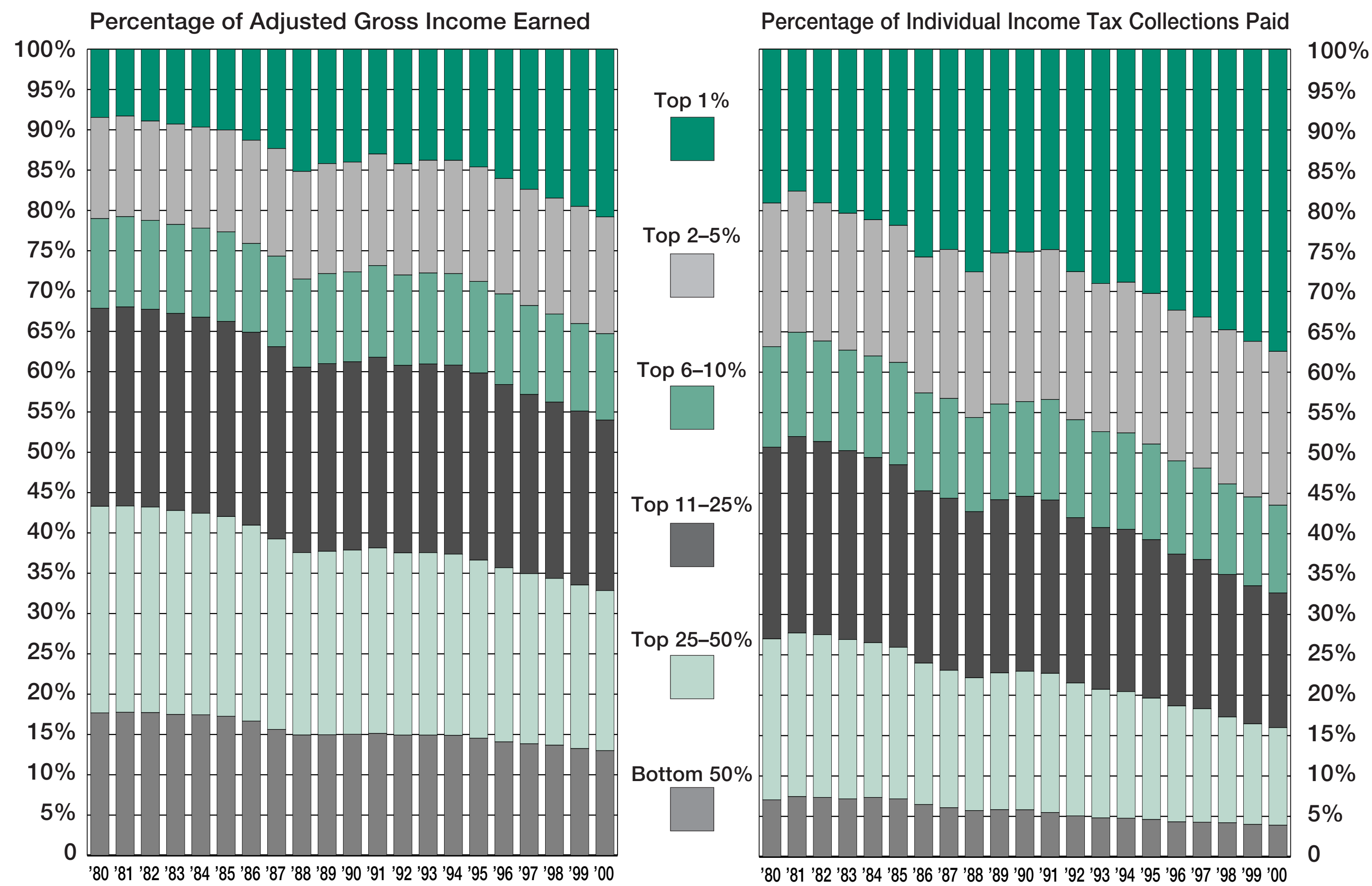
Of course, it is impossible to cut the income taxes of people with no tax liability, so groups that oppose tax cuts include these non-payers in their calculations of who benefits from President Bush's new proposal.

Unfortunately, even the Joint Tax Committee and Congressional Budget Office compute the impact of proposed income tax cuts in this way.

Statistics on non-paying filers:

- 46.7%, or 16.7 million, claim the child credit (total people in these households = 55.4 million);
- 74%, or 26.5 million, benefit from the Earned Income Credit;
- 23%, or 8.3 million, are single individuals;
- 5.6%, or 2 million, are childless couples, either seniors or working couples; and
- 12%, or 4.3 million, have some business income (Schedule C).

Figure 1: How Much Did We Earn and How Much Did We Pay?
1980–2000



65th National Conference Previews U.S. Effort to Replace FSC/ETI and Prevent Trade Sanctions

Morning Session on Tax Simplification Featured Pam Olson, Lindy Paull and Nina Olson

At noon on November 14th, Executive Director Scott A. Hodge welcomed a large crowd to the Tax Foundation's 65th National Conference.

Students had traveled from colleges around the region to participate in the Foundation's College Classroom Program (see box on page 13).

Keynote speaker Kenneth Dam, Deputy Secretary of the Treasury, explained the connections between the problems of corporate inversions and the WTO rejection of the ETI.

Hodge outlined the theme, "International Tax Reform: Is There a Win-Win Solution for Exporters and Multinationals?" explaining that the conference would present perspectives from the Administration, academia, and Captiol Hill on the question of how the U.S. should respond to the persistent rejection by the World Trade Organization of U.S. tax code provisions designed to boost exports.

The Administration's View of International Tax Reform

He then introduced the keynote speaker, Deputy Secretary of the Treasury Kenneth Dam, who described the Administration's vision for an internationally competitive tax code.

Dam dismissed any notion of reviving the Extraterritorial Income Exclusion Tax Act, the most recent version of a tax subsidy for exporters in U.S. law. He acknowledged that any replacement would hurt some exporters, but he insisted that a dramatically different replacement was inevitable, and that despite the pain, moving forward would be less painful than stalling.

He praised H.R. 5095, the international tax reform bill proposed by Rep. Bill Thomas, Chairman of the House Ways and Means Committee. (See full text of Sec. Dam's remarks on Tax Foundation web site.)

Recent Economic Research

Next, a panel of scholars discussed the economics of international tax reform: Dr. Mihir Desai, Assistant Professor of Finance, Harvard University; Dr. Kevin Hassett, Resident Scholar, American Enterprise Institute; and Dr. Douglas Shackelford, Meade Willis Professor of Taxation, Kenan-Flagler Business School, University of North Carolina.

Shackelford presented research on corporate tax returns that showed tax liabilities after acquisition by a foreign

Bob Perlman (r.), now a director with PricewaterhouseCoopers after many years with Intel, was surprised that Professor Shackelford's research on corporate mergers had been aided by the IRS's willingness to show him actual corporate tax returns, with no names or information withheld.

firm to be the same as similar firms acquired by U.S. firms. This result cast doubt on the common assertion that foreign firms enjoy a tax advantage over domestic firms.

Quite aside from these conclu-

Bill Archer (l.), former Chairman of the Ways and Means Committee; and Stuart Eizenstat, former Deputy Secretary of the Treasury, had worked together on the FSC/ETI problem. Now in the private sector, they discussed how the U.S. should respond to the WTO's threatened sanctions.

sions, Shackelford created a stir when he answered questions about his methodology. Many veteran corporate tax officers in the audience were shocked to learn that after Dr. Shackelford had submitted a detailed proposal to the IRS explaining how the public interest would be served by his research, he was given full access to recent corporate tax returns, with no information excised.

A panel of two former senior public officials followed. Stuart Eizenstat, former Deputy Secretary of the Treasury under President Clinton, joined Bill Archer, former Chairman of the House Ways and Means Committee. In these positions during the late 1990s,

Lindy Paull, longtime chief of the Joint Tax Committee's staff, discussed recent tax simplification work. She had not yet announced her intention to leave the Committee.

Archer and Eizenstat had worked together on the FSC/ETI issue. They agreed that the U.S. needs to be able to give its exporters the same sort of

Pamela Olson, Assistant Secretary of the Treasury for Tax Policy, flanked by Lindy Paull, Chief of Staff for the Joint Committee on Taxation, and Scott Hodge, the Tax Foundation's executive director.

incentives that foreign nations are able to, despite the complexities of doing so in the context of the U.S.'s direct corporate tax system.

Mr. Archer, now a senior policy analyst with PricewaterhouseCoopers, asserted that this issue should certainly be part of the Doha Round of the WTO Conference. Mr. Eizenstat, now with Covington & Burling, urged a continuous, bipartisan effort but pointed out that there is still time to negotiate. Europeans would be reluctant to see the potential $4 billion sanctions actually implemented, asserted Eizenstat, saying that they would instead prefer to resolve the issue in negotiations, and we should begin those talks.

Another panel of scholars, moderated by Professor Terrence Chorvat of George Mason University School of Law, was assigned to discuss the domestic benefits of multinational competitiveness: Edward Gresser of the Progressive Policy Institute, Stephen Entin of the Institute for Research on the Economics of Taxation, and Alan Reynolds of the Cato Institute.

National Taxpayer Advocate Nina Olson discusses the need for tax simplification with Tax Foundation Executive Director Scott Hodge.

For the final panel, Joseph Luby, Jr., Assistant General Tax Counsel, Exxon Mobil Corporation, introduced two speakers to address "Finding Common Ground on International Tax Reform." The Treasury Department's International Tax Counsel, Barbara Angus, presented the Administration's view against the that of the House Ways and Means Committee's Democratic Chief Tax Counsel, John Buckley.

A Progress Report on Tax Simplification

In the morning before the conference, a one-hour session on tax simplifications featured the National Taxpayer Advocate, Nina Olson; the Chief of Staff of the Joint Committee on Taxation, Lindy Paull; and the Assistant Secretary of the Treasury for Tax Policy, Pam Olson.

Much of the discussion focused on the alternative minimum tax because it is almost universally unpopular and because it is the best-known example of the monstrous complexity of our tax code.

Paull said the Joint Committee staff was considering a proposal for a uniform set of tax rules for pass-through entities, in addition to a congressionally required report on tax issues associated with the Enron debacle, including executive compensation.

College Classroom Project Brings Students Together with Corporate and Capitol Hill Tax Policy Community at Annual Conference

A generous donation to sponsor the conference was made by:

- Ernst & Young LLP

Other firms made per-student contributions to defray their costs.

At the conference, students met business leaders, well-known analysts and other prominent experts who shape tax policy.

Donors who sponsored students to come to Washington were:

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Students who participated in the College Classroom Project came from Bloomsburg University, George Washington University, George Mason University, Mansfield University, Regent University, and Yeshiva University.

Please contact Julie Burden (jburden@taxfoundation.org) about sponsoring next year.

Tax Foundation Dinner Celebrates 65th Year

Foundation Honors President Bush, Chairman Thomas, and Majority Leader Armey

President George W. Bush accepted the Tax Foundation's Distinguished Service Award at the Tax Foundation's 65th annual dinner on November 14th.

In his videotaped acceptance of the Tax Foundation's Distinguished Service Award, the President congratulated the Foundation on 65 years of service and promised to champion common sense tax reform (see complete text on TF web site.)

Each year the Foundation honors public officials or private sector individuals who have contributed notably to the national discussion of sensible tax policies.

Armey Honored for Contribution to Policy Debate

The evening's second honoree was House Majority Leader Dick Armey, retiring after his third term as Majority Leader. His campaign for a single-rate income tax with a large standard deduction has kept fundamental tax reform and simplification before the public throughout his 18-year congressional career.

U.S. Representative Dick Armey (R-TX) House Majority Leader

First elected in 1984, he attracted attention early by working with Democrats to pass legislation closing down over 100 obsolete military bases, saving taxpayers $4 billion per year.

In 1990, the Republican Conference passed Armey's resolution opposing new taxes to reduce the budget deficit, and two years later, he won the chairmanship of the Conference.

In 1994, Armey and colleagues published the "Contract with America," which Armey pressed as the new Majority Leader when Republicans took the majority in the 104th Congress.

Bill Thomas Honored

The evening's keynote speaker was Rep. Bill Thomas (R-CA), Chairman of the House Committee on Ways and Means, who accepted the Foundation's Distinguished Service Award.

Thomas was elected as the nation's top taxwriter in January 2001. He had chaired the Subcommittee on Health where he was instrumental in the passage of the "Health Insurance Portability and Accountability Act of 1996," as well as the "Medicare Preservation Act." In 1998, Thomas was appointed Administrative Chairman of the National Bipartisan Commission on the Future of Medicare.

Thomas has shepherded two major tax bills into law during his chairmanship of Ways and Means.

Signed into law in June of 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 cut income tax rates, changed the brackets, raised the child credit, greatly reduced the "marriage penalty" and repealed the estate tax (see lead article for details). It also provided numerous tax breaks for education spending and retirement plans.

In the aftermath of September 11, Thomas presided over passage of the Job Creation and Worker Assistance Act of 2002, which addressed a general weakening of the economy exacerbated by the tragedy. The bill was signed into law in March of 2002, increasing depreciation deductions for business investment, extending unemployment benefits for 13 weeks, and providing $5 billion in special breaks to revitalize Manhattan.

At right, Bill Thomas, Chairman of the Ways and Means Committee, poses with "his Chairman," Bill Archer, who presided over the Committee from 1994–2000, and who twice won the Foundation's Distinguished Service Award.

Thank You!

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FOUNDATION MESSAGE

Who Benefits from a Tax Cut?

Scott A. Hodge
Executive Director
Tax Foundation

Like you, I get a lot of junk e-mail. But I also read many messages from concerned taxpayers who give their insights into the tax code, and often their frustrations with it. Over the past six months, however, dozens of Tax Foundation supporters have e-mailed me the same parable that puts our tax system, and President Bush's tax cuts, in terms everyone can understand.

Despite my attempts to identify the author, he or she remains anonymous. (It is not, as some e-mails have claimed, an economics professor in South Dakota.) So while another urban legend lives on, I want to share this story with you and relate it to some of the research we have done recently on who does not pay taxes in America.

Suppose that every day, ten men go out for dinner. The bill for all ten comes to $100. They decided to pay their bill the way we pay our taxes, so they divided the bill like this:

The first four men — the poorest — would pay nothing. The fifth would pay $1, the sixth $3, the seventh $7, the eighth $12, the ninth $18, and the tenth man — the richest — would pay $59.

One day, the owner threw them a curve (in tax language, a tax cut).

"Since you are all such good customers," he said, "I'm going to reduce the cost of your daily meal by $20." So now dinner for the ten only cost $80.00.

The group still wanted to pay their bill the way we pay our taxes.

So the first four men were unaffected. They would still eat for free. But what about the other six — the paying customers? How could they divvy up the $20 windfall so that everyone would get his "fair share"?

The six men realized that $20 divided by six is $3.33. But if they subtracted that from everybody's share, then the fifth man and the sixth man would end up being PAID to eat their meal. So the restaurant owner suggested that it would be fair to reduce each man's bill by roughly the same amount.

And so the fifth man paid nothing, the sixth pitched in $2, the seventh paid $5, the eighth paid $9, the ninth paid $12, leaving the tenth man with a bill of $52 instead of his earlier $59. Each of the six was better off than before. And the first four continued to eat for free.

But once outside the restaurant, the men began to compare their savings. "I only got a dollar out of the $20," declared the sixth man, then, pointing to the tenth. "But he got $7!". "Yeah, that's right," exclaimed the fifth man, "I only saved a dollar, too. It's unfair that he got seven times more than me!"

"That's true!" shouted the seventh man, "Why should he get $7 back when I got only $2? The wealthy get all the breaks!"

"Wait a minute," yelled the first four men in unison, "We didn't get anything at all. The system exploits the poor!"

The nine men surrounded the tenth and beat him up. The next night he didn't show up for dinner, so the nine sat down and ate without him.

But when it came time to pay the bill, they discovered, a little late what was very important. They were FIFTY-TWO DOLLARS short of paying the bill! Imagine that!

And that, in a nutshell, is how the income tax system works. Like all e-mail stories, the numbers aren't exact — but see pages 10 and 11 for statistics that show how true-to-life this story is.

The people who pay the highest taxes get the most benefit from a tax cut. We don't have to feel sorry for them because they earn a lot too, but a fair tax cut goes to highly taxed people. If over-taxed, high earners will react predictably — they'll earn and invest less.

One of the most exciting projects we started last year at the Tax Foundation is called "Putting a Face on America's Tax Returns." The goal is to study the demographics of American taxpayers to find out who really bears the burden of taxes.

For example, although the "top 10 percent" of tax filers are routinely disdained in the press as being too rich to merit a tax cut, the Bureau of Labor Statistics tells us that an assistant high school principal married to an assistant fire chief is in the top 10 percent — statistically "rich", but decidedly middle-class by any reasonable standard.

When estimating the value of tax cuts, the January 12 edition of *Time* contained a typical presentation:

"Although Bush touted the fact that the average tax bill would shrink $1,083, almost half of all filers would get reductions of less than $100, according to the left-leaning Center on Budget and Policy Priorities."

The reason this statement is misleading is that the people who make up "almost half of all filers" owe almost no income taxes to begin with. Indeed, this year, 35.8 million tax filers (representing 69.6 million people) will have a zero tax liability. That is 26.7 percent of the roughly 133 million expected tax returns this year. The Bush plan will take 3.8 million more tax filers off the tax rolls (see story on page 11).

The bottom line is that it is impossible to give income tax relief to people who do not pay income taxes. Unfortunately, when Congress's Joint Tax Committee or Congressional Budget Office calculates the distributional impact of the President's plan on "taxpayers," they include all 133 million tax filers, including the millions who owe nothing.

If distributional analysis is to be the standard by which Washington judges any tax plan, then we should calculate the plan's benefits to *taxpayers* — those filers who have a positive income tax liability.

And that number shrinks with every new tax bill.

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Tax Foundation in the Media

Since President Bush unveiled his new tax plan on January 7, Tax Foundation research has been cited by CNN/Money, *The Wall Street Journal, The New York Times, Time Magazine, The New York Post, The Boston Globe,* CNBC and *The Los Angeles Times,* just to name those with the broadest circulation.

Stories On What the President's Tax Plan Would Save Families

Before the official release of the President's plan, Chief Economist John Barry projected the tax savings for a family of four with the median income in each of the 50 states, and CNN/Money and AOL ran a December 12 story about upcoming tax cuts that relied exclusively on Tax Foundation data and became CNN/Money's most popular story (most-viewed, emailed, and printed).

> ***"The economy is not a Harley-Davidson that can be kick-started with a one-time check."***
> ***— Scott Hodge on CNN***

This story ricocheted all over the country, but of course, families are different everywhere, so we've provided customized calculations for *The New York Post* whose readers include many high-income renters with fewer children, for the *Miami Herald* which wanted calculations similar to what *Time Magazine* printed (see table on page 1).

As a result of this coverage, CNN's Washington Office invited Tax Foundation Executive Director Scott Hodge to their studios on January 6th for an immediate response to the Democrats' proposed one-time rebate checks of $300 for individuals and $600 for couples.

Hodge pointed out the fallacy of mistaking a one-time windfall with economic stimulus: "The economy is not a Harley-Davidson that can be kick-started with a one-time check that covers last year's Christmas bills. Long-term economic growth comes from permanent changes in tax rates, especially the highest marginal rates."

Hodge and Barry have appeared on numerous radio shows explaining the impact on families, among them KDKA in Pittsburgh, WGN in Chicago, KTSA in San Antonio, WPGF in Raleigh, and KTAR in Phoenix.

Stories on "Class Warfare" and the Impact of Exempting Dividends

We published several short pieces to educate the public about taxable dividends, not exactly a hot topic until President Bush proposed exempting them from income tax. The *Wall Street Journal* quoted our estimate of how much each state's taxpayers would save, pointing out that some political opponents of exemption represent states that would benefit the most.

The *New York Times* carried a Tax Foundation interview about double taxation, in which Chief Economist John Barry explained all the ways that taxes multiply one upon the other.

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