

Putting a Face on America's Tax Returns





Sound Tax Reform Must Begin with a Solid Understanding of the Changing Face of American Taxpayers

By Scott A. Hodge

Introduction

For the first time in 20 years, Washington seems poised to overhaul the federal tax code. Americans are ready to support fundamental tax reform, judging from their responses to the 2005 Tax Foundation Annual Survey of U.S. Attitudes on Taxes and Wealth conducted by Harris Interactive. A majority of American adults believe federal taxes are too high, the tax code is too complex, and the income tax system is unfair. A majority support simplification even if it means giving up the deductions and exemptions they now enjoy.

The biggest obstacle to reform may not be the army of Washington lobbyists who will fight to protect those deductions and exemptions. The most serious obstacle

to reform is the fact that America has become divided between a growing class of people who pay no income taxes and a shrinking class of people who are bearing the lion's share of the burden.

Despite the charges of critics, the tax cuts enacted in 2001, 2003, and 2004 dramatically reduced the tax burden of low- and middle-income taxpayers and shifted the tax burden onto higher-income taxpayers. In 2004, one out of every three Americans who filed a tax return (42.5 million) had no tax liability after they took advantage of their credits and deductions, while millions more paid next to nothing. As a result, the top 20 percent of taxpayers – those earning more than roughly \$71,000 in 2004 – now pay over 80 percent of all the income taxes.

The widening gulf between the “payers” and the “non-payers” poses a dilemma for tax reformers. Generally speaking, the goal of tax reform is to broaden the tax base while lowering tax rates. But how can Congress craft a tax reform plan that (1) doesn’t raise taxes on the 42.5 million Americans who pay nothing and (2) doesn’t “cut taxes for the rich” who now pay everything? There is no easy answer.

The first step toward a solution is to understand how our progressive income tax rate system is interacting with the demographic changes that have occurred in America over the past 45 years. If we look at who comprises the top 20 percent of taxpayers, we find that they are the picture of most any suburban family:

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

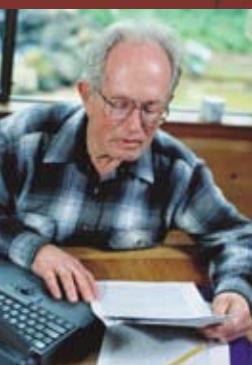
In many areas of America, these taxpayers are “middle class” by any standard. But these families are taxed at the highest income tax rates because our progressive tax rate system is not fully adjusted for such things as cost of living, age, education, or the number of incomes in a household. Unless we reform the tax code so that it is neutral to these demographic

traits, America’s suburban middle class may soon be the only “taxpayers” actually paying income taxes.

While no politically acceptable tax system can be fully adjusted for all of this nation’s vast differences, the most neutral system is a single-rate tax levied on consumption or on incomes above some level, say \$40,000 in annual income. Ideally, such a system should have as few deductions as possible and be applied to as broad a base as possible.

Not only would a tax system free of these distortions be better for the economy, but it would restore a sense of fairness and equity to a tax code that too often resembles the new car market – everyone pays a different price depending upon their ability to navigate the system.

Former House Majority Leader Dick Armey once said, “If we are going to respect the tax code, we need a tax code that respects us.” The only system that will respect all of the vast differences in America is a single-rate tax levied at a low rate on consumption or income. If lawmakers can finally muster the courage to move to such a system, “April 15th,” as former Louisiana Congressman Billy Tauzin once said, “will be just another beautiful spring day.”



Not Your Father's Middle Class

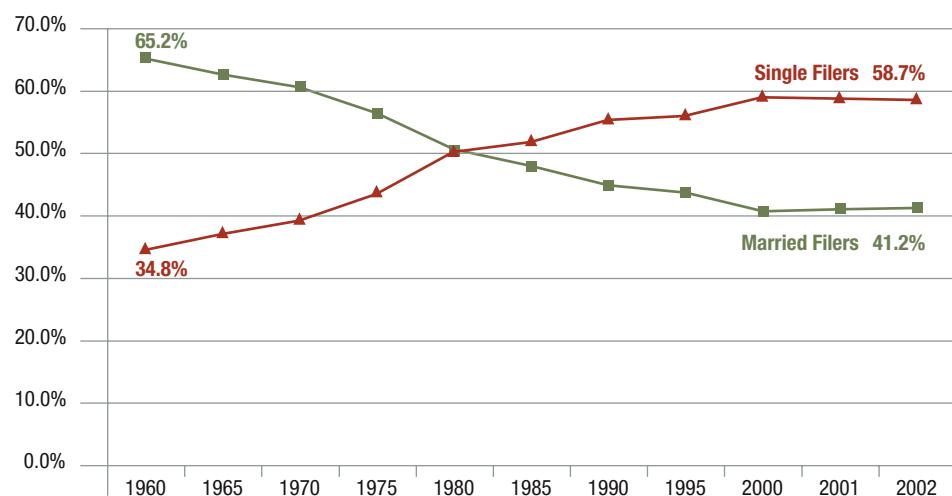
As lawmakers begin to debate the various tax reform plans under consideration, some groups will urge them to “protect the middle class” from any change in the tax burden they already bear. By middle class, it is usually meant those taxpayers in the statistical middle 20 percent of the income scale – those taxpayers earning between roughly \$25,000 and \$42,000 per year.

But over the past few decades, the composition of American taxpayers has changed dramatically – especially among those taxpayers in the statistical middle. The stereotype of “Ozzie and Harriet,” the married, single-earner family of the 1950s, is no longer typical in the middle one-fifth of the income scale. On the con-

trary, the middle one-fifth of the income scale looks more like the cast from the popular TV program “Friends” – single individuals and unmarried parents with children.

Chart #1 shows the gradual transformation of America from a nation of married taxpayers to a nation of single taxpayers. In 1960 some 65 percent of all tax returns were filed by married couples whereas 35 percent were filed by single individuals (including head-of-household filers). By 1980, the number of married filers and single filers were roughly equal. Today, the composition of taxpayers is nearly the reverse of what it was in 1960; nearly 60 percent of filers are single, while roughly 40 percent are married.

Chart 1: Singles Now File the Majority of Tax Returns



Note: “Single” includes heads of households, and “married” includes married filing separately.
Source: IRS

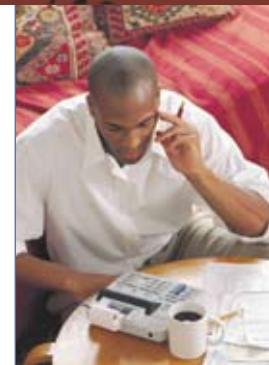


Table 1: Historical Composition of Tax Filers by Filing Status

Year	Married, Separate	Married, Joint	Married Total	Head of Household	Single	Single Total
1960	3.3%	61.9%	65.2%	1.7%	33.1%	34.8%
1965	4.2%	58.4%	62.6%	2.8%	34.5%	37.3%
1970	3.2%	57.4%	60.6%	4.8%	34.6%	39.4%
1975	2.4%	53.9%	56.3%	6.1%	37.7%	43.8%
1980	1.8%	48.7%	50.5%	8.3%	42.0%	50.3%
1985	0.9%	47.1%	48.0%	9.9%	42.1%	52.0%
1990	1.9%	42.9%	44.8%	11.6%	43.9%	55.5%
1995	2.2%	41.5%	43.7%	13.2%	43.0%	56.2%
2000	1.9%	38.9%	40.8%	14.1%	45.1%	59.2%
2001	1.9%	39.2%	41.1%	14.2%	44.7%	58.9%
2002	1.8%	39.4%	41.2%	14.7%	44.0%	58.7%
2003	1.8%	39.5%	41.3%	15.0%	43.7%	58.7%

Source: IRS

Table #1 shows this transformation in greater detail, separating the two types of married filers (married filing separately and married filing jointly) and the two types of single filers (single and head of household). Remarkably, in 1990 single filers overtook married filing jointly as the largest filing status of all taxpayers and now outnumber all married filers combined.

The explosive growth in the number of single taxpayers – and single-parent households – over the past four decades has had a profound effect on the composition of the statistical “middle class” and on the overall distribution of income of all taxpayers. Indeed, much of the recent concern over the “shrinking middle class” or the rising income disparity between the “rich” and “poor” can be attributed to the growing army of single taxpayers flooding the lower income

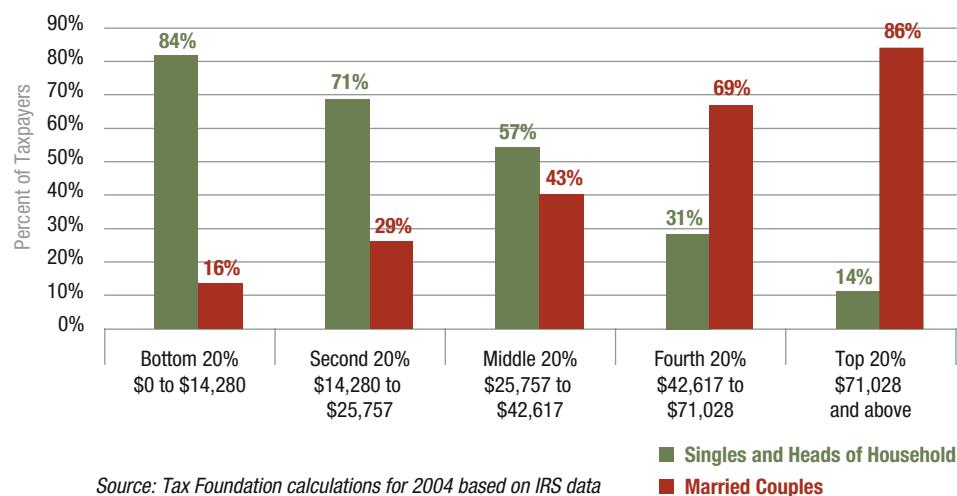
groups and pushing married couples (who we’ll see are often dual-income, older, and better educated) into ever higher income groups.

Chart #2 shows the composition of filing status within the major income groups. In an almost mirror image of each other, the lower income groups are dominated by single filers while the upper income groups are overwhelmingly populated by married filers.

Among the bottom 20 percent of taxpayers, 84 percent are single while just 16 percent are married. By contrast, 86 percent of those taxpayers in the top 20 percent are married while just 14 percent are single. As we’ll see later, many of these high-income married couples are simply dual-income. It’s easy to see that with two incomes, working couples appear twice as wealthy as single individuals.



Chart 2: Married Couples Are Called “Upper-Income,” Singles “Lower-Income”



Just as interesting, however, is the composition of taxpayers within the statistical middle. Chart #2 shows that a majority of taxpayers within the “middle class” are either single individuals or single parents with children, while a 43 percent minority are married couples.

What this means is that over the past four decades Ozzie and Harriet have been largely displaced in the statistical middle by single workers, a fact that requires us to revise our conceptions of the term “middle class.” For most Americans, the term “middle class” is more than a point on some statistical income scale. It represents a value system that binds people across income levels.

The 2005 Tax Foundation Annual Survey of U.S. Attitudes on Taxes and Wealth asked those polled if they considered themselves “lower class,” “middle class,” or “upper class.” As with most surveys, the majority of respondents viewed themselves as middle class. Only 2 percent of U.S. adults consider themselves upper-class, and fully 79 percent say they are lower-middle, middle, or upper-middle class.

That said, when we think of a stereotypical “middle-class” taxpayer, our image is that of an intact family with children, not a single male in his first job out of college. If that is what most people think of as middle class, then, as we will soon see, the new middle class is actually at the upper end of the income scale and appears statistically “rich” on paper.

A Tale of Two Americas: Payers and Non-Payers

In addition to America becoming divided between single and married taxpayers, we are also becoming divided between those who pay income taxes and those who pay no income taxes.

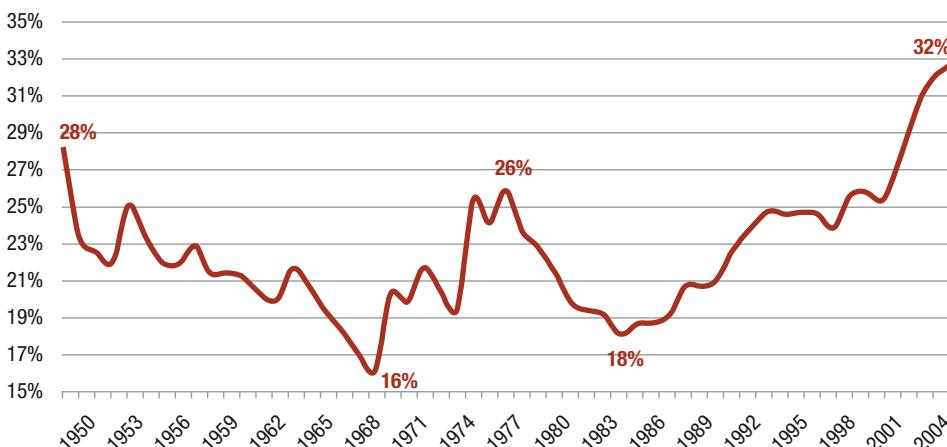
Many of the tax cuts enacted over the past four years – specifically the doubling of the child credit to \$1,000 and the introduction of the new 10 percent bracket – were targeted to help taxpay- ers in the statistical middle class. It is unlikely that lawmakers understood how powerful these measures would be – not only lowering the tax burden for millions of lower- and middle-income taxpayers, but knocking millions of people off the tax rolls entirely – turning them into non-paying tax filers.

Tax Foundation economists estimate that in 2004, some 42.5 million Americans (one-third of all filers) filed a tax return but had no tax liability after taking ad- vantage of their credits and deductions.

Chart #3 shows the percentage of non- payers between 1950 and 2004. During that period, non-payers averaged 22 percent of all tax filers. Today, however, non-payers account for 32 percent of all tax filers, a nearly 50 percent increase in the number of non-payers since 2000 and a 160 percent increase in the number of non-payers since 1985.

Individuals and families who earn enough to file a tax return can eliminate their tax liability by taking advantage of credits and deductions in the tax code. Many of these are familiar to all tax filers: the personal exemption was worth \$3,100 in 2004, and the standard deduction was worth \$4,850 for singles and \$9,700 for married couples. For tax filers who have itemized deductions that exceed the standard deduction, there are the amounts paid for mortgage interest or given to charity, as well as various education-related deductions. Business owners can take advantage of an even wider array of credits and deductions to reduce their tax liability.

Chart 3: Percentage of Tax Filers Who Pay No Income Tax, 1950 – 2004



Source: IRS, Tax Foundation Individual Tax Model





In 1997, Congress enacted a new \$500 per-child tax credit and expanded the Earned Income Tax Credit (EITC) for low-income workers. The 2001 and 2003 tax cuts increased the value of the child credit to \$1,000 in 2004. These two tax credits – especially the child credit – have had a powerful effect on reducing, and in many cases eliminating, the income tax liability for millions of Americans.

These two credits are unique in that taxpayers can receive the full value of the credit even if they have no tax liability. To see how this works, consider a couple that earns \$40,000 per year and has three children. Their three children make them eligible to receive \$3,000 in tax credits ($3 \times \$1,000$) but, as the nearby example shows, they have a tax liability of \$1,505. Under the rules of most tax credits, this family would only be allowed \$1,505 in tax relief – an amount equal to their tax liability. But a “refundable” tax credit gives this family the full amount they are eligible for – \$1,505 toward their tax liability, and the remaining \$1,495 in the form of a check, called a refund even though it is new money, not “refunded” in the normal sense of the word.

How “Refundable” Tax Credits Work

Married Couple with Three Children

Adjusted Gross Income in 2004

Minus Standard Deduction

Minus Personal Exemptions

Taxable Income

Gross Taxes Owed

Minus 3 Child Credits

Taxes Owed

“Refundable” Credit Received

Of the 42.5 million tax returns that pay no income taxes, roughly 53 percent received some form of a refundable credit – either the EITC or the child tax credit. In 2004, Uncle Sam paid out about \$33 billion in “refund” checks to the families and single individuals who qualified for the Earned Income Credit and another \$9 billion to families who were eligible for the child credit.

Chart #4 demonstrates the effect that refundable credits have in not only erasing the income tax burden for the lowest-income Americans, but transferring income from wealthier taxpayers and, thereby, shifting the burden further up the income scale. For example, before accounting for refundable tax credits, the bottom 20 percent of taxpayers shouldered 0.2 percent of the income tax burden while the top 20 percent of taxpayers paid roughly 79 percent. After receiving more than \$28 billion in refundable credits, the bottom 20 percent of taxpayers is found to receive more than they pay, while the burden on the top 20 percent increased to nearly 84 percent. The chart also shows that the refundable credits reduce the tax burden for the second

Tax Liability Under 2004 Tax Law

\$40,000

– \$9,700

– \$15,500

\$14,800

\$1,505

– \$3,000

\$0

\$1,495

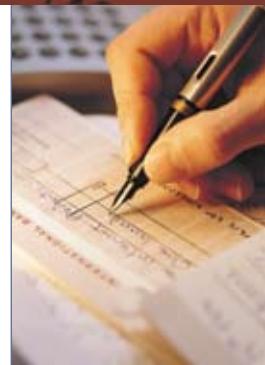
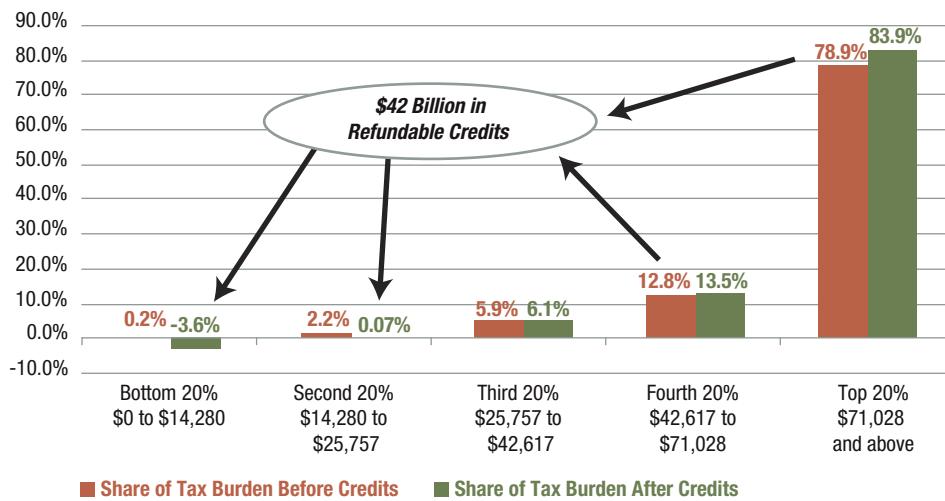


Chart 4: Effect of Refundable Tax Credits on the Distribution of the Income Tax Burden



Source: IRS, Tax Foundation Individual Tax Model

quintile to almost zero while increasing the tax burden for the third and fourth quintiles – though less dramatically than for the top income group.

Broadly speaking, the 42.5 million non-payers are:

- **Low-income:** 97 percent earn less than \$40,000 annually;
- **Young:** 36 percent are younger than age 25 and 56 percent are younger than age 35;
- **Women and Unmarried:** 54 percent are single women or female-headed households;
- **Part-Time Workers:** 42 percent work part-time while just 20 percent work full-time but less than 50 weeks a year;
- **Beneficiaries of Tax Credits:** 34 percent claim the EITC while 50 percent claim the child credit.

In addition to these non-paying filers, roughly 15 million individuals and families earned some income in 2004 but not enough to be required to file a tax return. When these non-filers are added to the non-payers, they add up to 57.5 million income-earning households (sometimes referred to as tax units) who paid no income taxes last year.

Even 57.5 million is not the actual number of people because one tax return often represents several people. When all of the dependents of these income-producing households are counted, roughly 120 million Americans – 40 percent of the U.S. population – are outside of the federal income tax system.

While some may applaud the fact that millions of low- and middle-income families pay no income taxes, there is a threat to the fabric of our democracy when so many Americans are not only disconnected from the costs of



government but are net consumers of government benefits. The conditions are ripe for social conflict if these voters begin to demand more government benefits because they know others will bear the costs.

The 2005 Tax Foundation Annual Survey of U.S. Attitudes on Taxes and Wealth found that 59 percent of American adults said it is unfair that 42.5 million Americans pay no federal income taxes after deductions and credits, and that everyone should be required to pay some minimum amount to fund government.

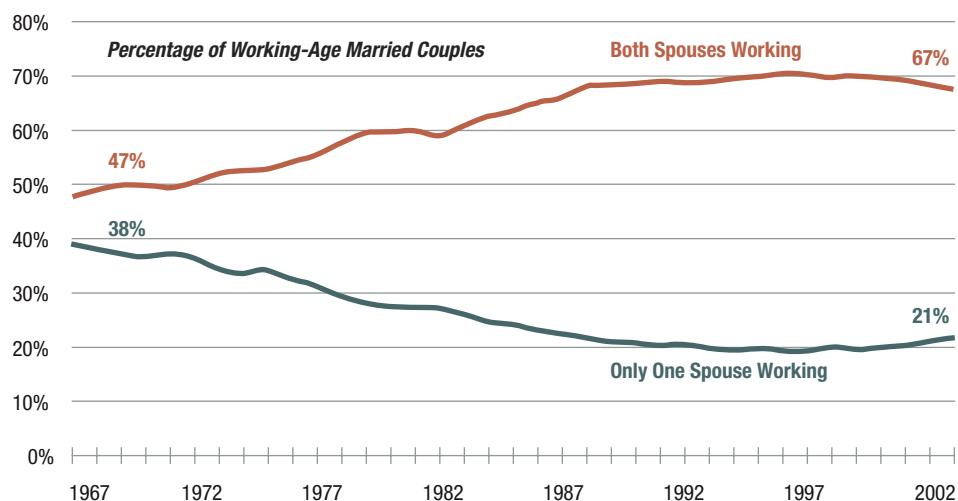
Who Pays the Income Taxes in America?

As explained above, the vast majority of taxpayers who face the highest marginal tax rates tend to be married couples. But aside from being married, they also tend to be dual-income, residents of high-cost urban areas, older, college educated, and engaged in business activities. Each of these characteristics makes them more likely to be exposed to the highest marginal tax rates.

Dual-Income Couples

If Ozzie and Harriet ever existed outside of our television screens, they are now certainly living comfortably in retirement. Over the past four decades, America has become a nation of dual-income working couples who, at least on paper, are statistically

Chart 5: America Has Become a Nation of Dual-Income Working Couples



high-income – especially when compared to the vast number of single taxpayers who populate the lower-income groups.

Chart #5 shows the growth in dual-income working couples since the mid-1960s. In 1967, less than half of all working couples were dual-income. Today, nearly 7 out of 10 working-age couples are dual-income. Between 1980 and 2003, the number of dual-income working-age couples grew by nearly 8 million, or 31 percent, from 29.5 million to 33.2 million.

When two single workers get married, they can quickly move from the statistical middle into the so-called “rich.”

For example, a young factory worker earning \$18 an hour – or \$36,700 per year – clearly falls into the statistical middle. But if she marries a man earning the same amount, their combined income of \$73,400 is enough to qualify them to be in the top 20 percent of Americans. Thus a family can have two “middle-class” jobs with two middle-income salaries, but still be considered statistically high-income according to IRS data.

Using the Tax Foundation’s matched IRS/Census database (which blends sterile tax data with demographically rich Census data), Foundation economists created a basic profile of dual-income working couples.

Not surprisingly, dual-income couples are largely found in upper-income groups, as standard income distribution tables such as Table #2 shows. More than 73 percent of dual-income couples are in

the top two income groups (quintiles). Indeed, 41 percent earn enough to be among the top 20 percent of taxpayers. While dual-income couples comprise just 25 percent of all taxpayers, they comprise nearly 45 percent of the fourth quintile and nearly 62 percent of the top quintile.

Because so many dual-income couples face the highest marginal rates, they pay 44 percent of all income taxes and nearly half of all income taxes paid by the top 20 percent of taxpayers.

However, many low-income working couples do benefit substantially from the refundable child credit and Earned Income Tax Credit. As a group, working couples in the bottom two quintiles get more money back in refundable credits than they pay.

As is shown in Table #3, dual-income couples are overwhelmingly between the ages of 35 and 54 and are in their peak earning years. So it is natural that they would be among the higher-income taxpayers. However, as will be shown later, this is only a snapshot in time of their lives. As they reach retirement, they will likely live on a fixed income and move down to the lower rungs of the income scale.

Table #4 shows that dual-income couples tend to work in professional or skilled jobs. It is, therefore, no surprise that when two single professionals get married, their combined income leapfrogs them into the highest income group.





Table 2: Dual-Income Couples Tend to Be Higher-Income

<i>Income Group</i>	<i>As a Share of All Taxpayers</i>	<i>Percentage of Dual-Income Within Each Group</i>
Bottom 20% (\$0 – \$14,280)	3.3%	3.6%
Second 20% (\$14,280 – \$25,757)	7.3%	8.8%
Third 20% (\$25,757 – \$42,617)	16.1%	20.9%
Fourth 20% (\$42,617 – \$71,028)	32.4%	44.7%
Top 20% (\$71,028 and above)	40.9%	61.8%
Total	100%	25.5%

Source: IRS, Tax Foundation Individual Tax Model

Table 3: Dual-Income Couples Tend to be in Peak Earning Years

<i>Age</i>	<i>Percentage of Couples in Age Group</i>
18-24	22.8%
35-44	33.2%
45-54	32.1%
55 and above	11.9%

Source: IRS, Tax Foundation Individual Tax Model

Table 4: Dual-Income Couples Tend to Be Professional or Skilled Workers

<i>Leading Occupations of Dual-Income Couples</i>	<i>Count</i>	<i>Percent</i>
Executive, administrative & managerial	5,403,749	18.3%
Professional specialty	4,917,108	16.6%
Technicians & related support	945,000	3.2%
Sales	3,234,501	11.0%
Administrative support	2,769,500	9.4%
Other service	1,767,181	6.0%
Precision production and crafts	4,241,888	14.4%
Machine operators and assemblers	1,650,779	5.6%
Transportation	1,258,815	4.3%
Handlers, equipment cleaners, etc.	668,669	2.3%
Farming, forestry & fishing	742,833	2.5%

Source: IRS, Tax Foundation Individual Tax Model

Table 5: Cost of Living Has a Dramatic Impact on Tax Liability and Effective Tax Rates

<i>Metro Area</i>	<i>The Income You Need to Buy Median Standard of Living*</i>	<i>Puts You in This Group of Taxpayers</i>	<i>With This Tax Liability in 2004</i>	<i>With This Effective Tax Rate</i>
Houston	\$ 67,315	Top 25%	\$ 6,999	10.4%
National Average (Milwaukee)	\$ 74,443	Top 20%	\$ 8,081	10.9%
Orange County, CA	\$ 100,079	Top 10%	\$ 14,506	14.5%
San Francisco, CA	\$ 135,003	Top 5%	\$ 23,250	17.2%
New York City (Manhattan)	\$ 162,974	Top 3%	\$ 31,139	19.1%

**Married Dual-Income Couple in 2004, No Children*

Source: Tax Foundation calculations based on ACCRA data

Cost of Living and Tax Burdens

Anyone who has faced a job transfer or promotion has had to come to grips with the fact that a dollar of income earned in one region of America does not always buy the same standard of living as a dollar earned in another region. Yet many in the rising class of dual-income working couples live in high-cost urban areas and have incomes to match where they live. However, the tax code doesn't account for this and these couples pay the price in higher taxes even though their standard of living may be no better than a similar couple earning thousands less in a lower cost community.

To demonstrate how cost of living can affect a family's tax liability, Tax Foundation economists adjusted the income of a median, dual-income childless married couple to various cities using a cost-of-living index published by ACCRA, one of the nation's leading providers of cost-of-living data.

In 2004, the typical dual-income childless couple in America earned \$74,443 – an income large enough to put them into the top 20 percent of taxpayers, with a tax liability of roughly \$8,081 and an effective federal income tax rate of 10.4 percent. As it happens, the city with the closest average income to the national average is Milwaukee, Wisconsin. (See Table #5.)

Let's assume this Milwaukee couple is transferred to Orange County, California. In order to purchase the same standard of living they enjoyed in Milwaukee, this couple would need to earn more than \$100,000 per year. However, that cost-of-living-adjusted pay raise is enough to put them among the top 10 percent of taxpayers. At this new income level, their tax bill grows to \$14,506 and their effective tax rate jumps to 14.5 percent, yet their standard of living hasn't changed.

For a more extreme example, take that same couple and transplant them to New York City. To maintain the same standard of living they had in Milwaukee and



Orange County, they would need a joint income of nearly \$163,000. This income thrusts them into the top 3 percent of taxpayers and boosts their tax liability to more than \$31,000 per year and their effective rate to 19.1 percent.

In terms of economic purchasing power, this illustrative couple has the same standard of living in each of these cities. But because our progressive tax rate structure is not adjusted to the varied cost of living throughout the United States, they face dramatically higher effective tax rates and tax payments simply by moving to a higher cost metropolitan area.

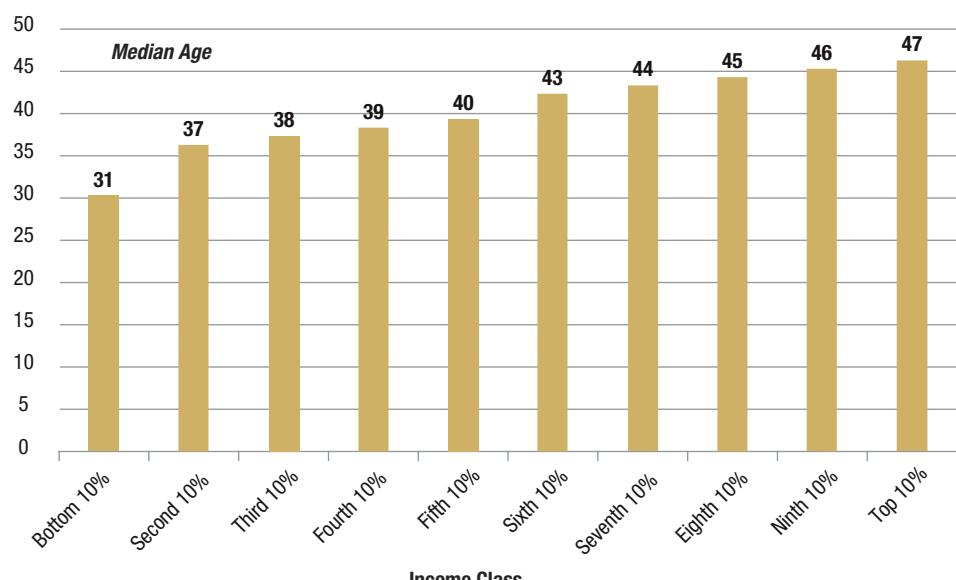
Nationally, it is difficult to calculate the total amount of “phantom” income that is being taxed at the highest marginal tax rates because of the large concentration of dual-income couples living in high-cost urban areas, but it is likely in the tens of billions of dollars.

While the tax code was indexed for inflation in 1985 to protect Americans from “bracket creep,” nothing has been done to protect them from “cost of living creep.” For some couples, the home mortgage interest deduction may provide some protection from rising housing costs, but the Alternative Minimum Tax can equally lessen some of that protection for families in high-cost, high-tax areas.

Life Cycle and Income “Inequality”

One of the more overlooked explanations for the difference in incomes between taxpayers is the issue of life cycle. In our younger years, we typically work part-time, low-income jobs as we complete high school or college. In our 20s, we begin our formal careers with our first full-time position. By the time we reach our 30s and 40s, we are well into the

Chart 6: Taxpayers’ Age Explains Income “Inequality”



Source: IRS, Tax Foundation Individual Tax Model



Table 6: Taxpayers' Age Explains Income "Inequality"

Age						
Income Group	18 - 24	25 - 34	35 - 44	45 - 54	55 - 64	65 +
Bottom 20%	30.6%	19.2%	16.0%	11.2%	8%	15%
Second 20%	15.9%	25.0%	21.8%	14.0%	9%	15%
Third 20%	6.1%	24.5%	27.1%	20.2%	10%	12%
Fourth 20%	1.6%	19.5%	29.6%	25.6%	13%	11%
Top 20%	0.6%	12.6%	29.6%	34.3%	14%	9%
Subtotal	12.5%	20.6%	24.1%	19.8%	10%	13%

Source: IRS, Tax Foundation Individual Tax Model

swing of our careers as we advance up the job ladder of our chosen fields. By the time we are ready to retire, we've reached the peak of our earning potential. When we do retire, we circle back to the bottom of the income scale, living on a fixed income.

Tax Foundation economists used our matched IRS/Census database to calculate the median age of taxpayers within each income group. In the event that a tax return represented two or more wage earners, we included only the age of the primary earner.

Chart #6 shows that higher-income taxpayers are 50 percent older than their low-income neighbors. Overall, the lowest-income taxpayers (those in the bottom 10 percent) have a median age of 31 years. Looking at the remaining income groups reveals the progression of taxpayers' incomes as they age in the workforce. Taxpayers in the middle 10 percent group have a median age of 40, while those in the top 10 percent have a median age of 47.

Table #6 shows in greater detail the age composition of each income quintile. The lowest-income groups are overwhelmingly populated by younger taxpayers, while the upper-income groups are overwhelmingly populated by much older taxpayers.

For example, fully 31 percent of taxpayers within the bottom income group are younger than age 24 – the years in which most workers have yet to set upon a career. Indeed, more than 50 percent of these low-income taxpayers are younger than age 34 and early in their careers, while 15 percent are older than age 65 and are likely retired.

By contrast, nearly half (49 percent) of taxpayers in the top income group are clustered in the pre-retirement ages of 45 to 64 – the years in which most workers reach their peak earnings – while only 13.3 percent are younger than age 34. It is likely that most of these young, upper-income taxpayers are the primary earner of a dual-income tax return with a joint income of more than \$71,000.

For example, an entry level computer



programmer earning \$40,000 married to an elementary school teacher earning \$35,000 have a dual-income large enough to be in the top 20 percent of taxpayers.

These figures indicate that the life cycle of American workers is a contributing factor causing the income inequality that appears to exist among taxpayers when a one-year snapshot such as a distribution table is used. As workers get older, they earn more and will naturally be wealthier than younger taxpayers who have scarcely begun their careers.

These findings also have very important policy implications. It means that reductions in the highest marginal tax rates will disproportionately benefit older taxpayers who are preparing for retirement, providing them more disposable income for retirement savings.

Educational Attainment and Taxpayer Incomes

For most Americans, a college education is the ticket to a good job, a higher income, and a better standard of living. But a college education is also the ticket to a higher tax rate.

As Table #7 shows very clearly, lower-income taxpayers have lower levels of educational achievement, while higher-income taxpayers have higher levels of educational achievement. For example, of those taxpayers in the lowest income group, 62 percent have a high school degree or less, while 28 percent have some college experience and just 10 percent have a bachelor's degree or more.

As we look further up the income scale, the percentage of taxpayers with a high school degree or less falls sharply while the number with some college or better grows considerably. Among those taxpayers in the top 20 percent, more than 8 out of 10 have some college education or better.

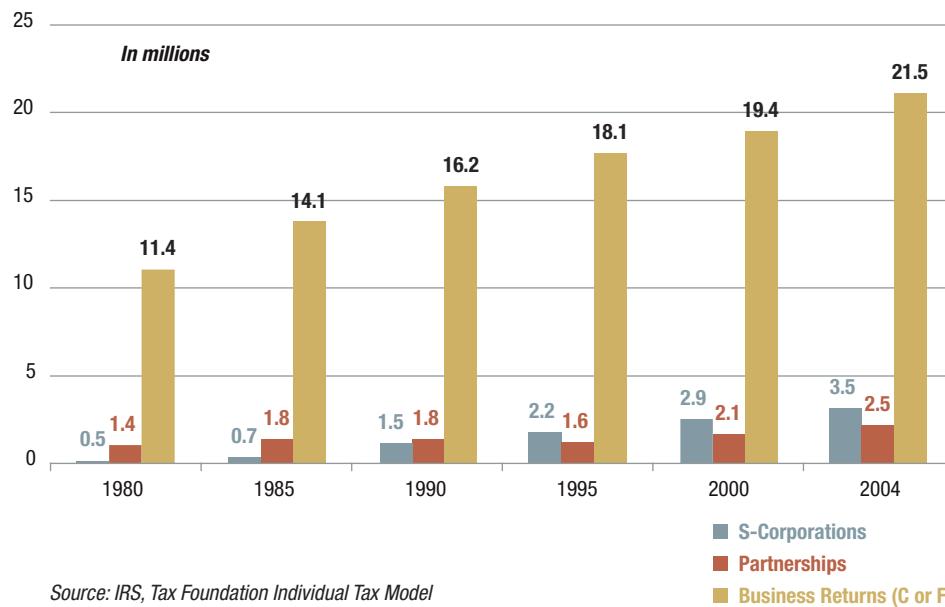
This illustrates an ironic result of our progressive tax rate system and our national efforts to encourage young

Table 7: College Educated Workers Tend to Be High-Income Taxpayers

	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%
Less than High School	25.1%	15.9%	10.1%	5.9%	2.0%
High School Diploma	36.8%	40.0%	34.1%	30.6%	17.4%
Some College or Associate's	28.4%	30.0%	30.6%	30.1%	24.4%
Bachelor's or Above	9.7%	14.0%	25.2%	33.4%	56.2%

Source: IRS, Tax Foundation Individual Tax Model

Chart 7: Growth in Types of Individual Business Ownership 1980 – 2004



Source: IRS, Tax Foundation Individual Tax Model

students to get a college education – there is a stiff tax penalty for achieving a college education. On the one hand, Washington spends billions of dollars assisting children of lower and lower-middle income families get a college education as a means of climbing the social and economic ladder. On the other hand, federal policy penalizes those who succeed in their educational attainment with higher marginal tax rates. Clearly contradictory messages.

Moving to a single-rate tax on consumption or income would help eliminate this inconsistency, and remove the “education penalty” embedded in the progressive rate structure of the federal tax code.

High-Income Taxpayers are Our Entrepreneurial Class

Over the past 25 years, the number of taxpayers reporting business activity on their individual tax returns has grown at an exceptionally rapid rate. Between 1980 and 2004, as shown in Chart #7, the total number of sole proprietorships, partnerships, farms, and S-Corporations more than doubled, from 13.3 million in 1980 to 27.5 million in 2004. S-Corporations alone grew almost seven-fold, from 545,389 in 1980 to roughly 3.5 million in 2004, and they now far exceed the number of conventional C-Corporations.

When we look carefully at the distribution of these tax returns, a clear picture emerges: an extraordinarily high proportion of high-income taxpayers have some form of business income (schedule C, E,



or F) and as their incomes rise, so too does the likelihood that they have business activity.

Overall, as is shown in Chart #8, 43 percent of taxpayers in the top 20 percent have business income, twice the percentage of those in the middle income group. Of those taxpayers in the top 1 percent – those earning more than \$300,000 and subject to the highest marginal tax rates – nearly three quarters have business income. And for taxpayers with incomes above \$1 million per year, nearly 83 percent have business income.

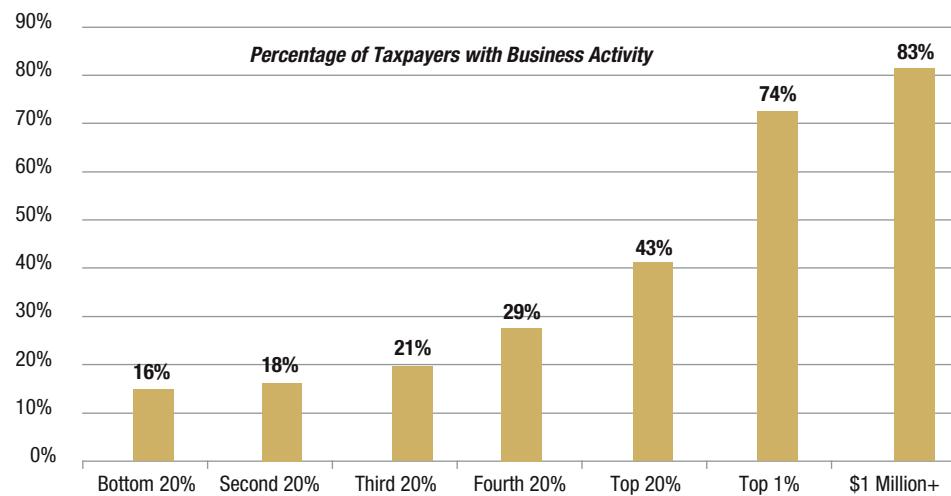
Remarkably, because so many taxpayers now have business income (or are paying their business's taxes through their individual tax form), Tax Foundation economists estimate that taxpayers with business income paid 54.3 percent of all individual income taxes in 2004.

What this means is that calls to shift the tax burden even further up the income scale will, in fact, end up penalizing business owners and entrepreneurs, endangering our long-term economic vitality.

Conclusion and Policy Recommendations

Tax policy should be used solely as a means of raising sufficient funds for government programs. It should not be a tool for social policy – either to punish one group of taxpayers or enrich another group. Yet it is clear that this nation's attempts to use progressive tax rates to make the wealthy pay more, while using targeted tax measures to reduce the burden on the middle class, has created two Americas – the “payers” and the “non-payers.” Within this bifurcated America are the seeds for social conflict and the undermining of our democratic institutions.

Chart 8: High-Income Taxpayers Are More Likely to Have Business Activity

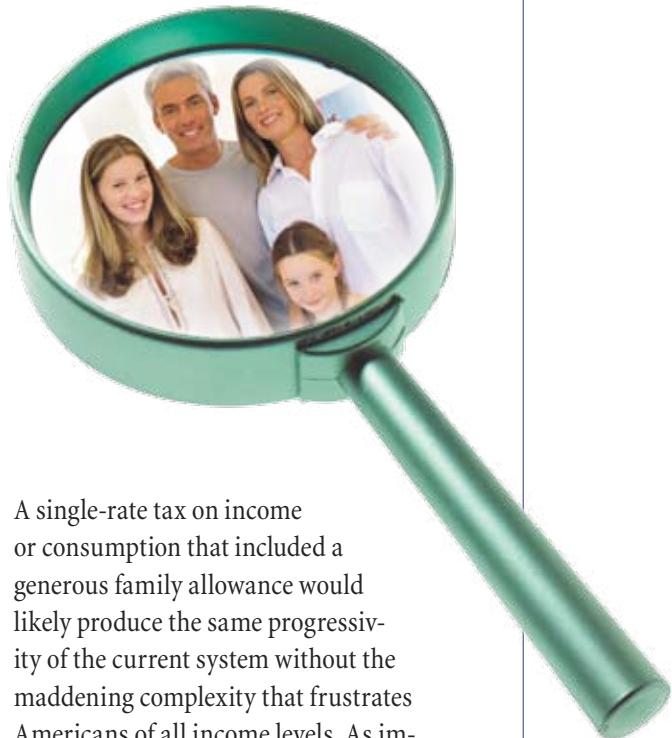


Source: IRS, Tax Foundation Individual Tax Model

The only way to mitigate the punishing effects of our current progressive rate structure on dual-income couples, older workers, the college educated, business owners, and families living in high-cost communities is to enact a single-rate tax levied on consumption or on incomes. Such a tax should be set at a low rate, applied to a broad base, and have as few deductions as is politically possible.

Despite polls indicating that Americans would prefer that every taxpayer pay at least something toward the cost of government, many lawmakers will undoubtedly balk at the prospect of bringing at least 42.5 million Americans back on the income tax rolls.

One solution is to structure a flat-rate system that roughly mirrors the distribution of the current system and protects those who are already non-payers. For example, under the current system, a married couple with two children earning \$40,000 per year is likely to pay no income taxes after taking advantage of the standard deduction, personal exemption, and child credits (\$1,000 for each child). A flat-rate system, such as the proposal being advocated by former presidential candidate Steve Forbes, would hold this family harmless by providing a generous family allowance – a zero tax rate on the first \$46,000 of income for a family of four – then apply the single-rate tax to every dollar above that income level.



A single-rate tax on income or consumption that included a generous family allowance would likely produce the same progressivity of the current system without the maddening complexity that frustrates Americans of all income levels. As importantly, such a system would mitigate the harmful effects of high marginal tax rates on dual-income married couples, families living in high-cost urban areas, older and educated taxpayers, and the growing number of business owners. In the end, the U.S. economy will be stronger and more dynamic as a result.

The bottom line is that the American economy will never be as strong as it can be so long as we perpetuate a tax system that punishes the very values we hold dear: intact married families, hard work, education, and entrepreneurship. These values can be protected and the economy unleashed if Washington can move beyond politics and scrap the current tax system and replace it with a single, low-rate tax on consumption or income.



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