



# FISCAL FACT

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## **Both Candidates' Tax Plans Will Reduce Millions of Taxpayers' Liability to Zero (or Less)**

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### *Almost Half of Tax Returns Could Reclaim Every Dollar Withheld During the Year*

One of the biggest challenges facing both John McCain and Barack Obama in their commitment to provide tax relief to working-class Americans is the simple fact that millions of them already pay no personal income taxes.

According to the most recent IRS statistics for 2006, some 45.6 million tax filers—one-third of all filers—have no tax liability after taking their credits and deductions. For good or ill, this is a dramatic 57 percent increase since 2000 in the number of Americans who pay no personal income taxes.

Tax Foundation estimates show that if all of the Obama tax provisions were enacted in 2009, the number of these "nonpayers" would rise by about 16 million, to 63 million overall. If all of the McCain tax proposals were enacted in 2009, the number of nonpayers would rise by about 15 million, to a total of 62 million overall.

The tax code has always contained provisions that reduce the income tax burden for low-income workers, such as the standard deduction, personal exemption, and dependent exemption. Between 1950 and 1990, the percentage of tax filers whose entire tax liability was wiped out by these provisions averaged 21 percent. Since then, lawmakers have expanded credits—such as the earned income tax credit (EITC)—while creating a plethora of new

credits, including the child tax credit, the HOPE credit, lifetime learning credit, and the credit for adoption expenses.

Most tax credits can only reduce a taxpayer's amount due to zero, but the EITC and the child tax credit were also made refundable, meaning that taxpayers are eligible to receive a check even if they have paid no income tax during the year. Those tax returns have become, in effect, a claim form for a subsidy delivered through the tax system rather than a direct payment from a traditional government program like welfare or farm supports.

As shown in Table 1 below, the Tax Foundation estimates that there will be 47 million tax returns with zero income tax liability in 2009 under current law. That's one-third of all tax returns, and those 47 million tax returns represent 96 million individuals.

Both the McCain and Obama plans would increase this number by expanding existing tax benefits or creating new ones. Senator McCain is proposing one expanded provision—the dependent exemption—and one new credit, a \$5,000 refundable health care tax credit. The Obama plan contains seven new provisions, including a new "Making Work Pay Credit," a "Universal Mortgage Credit," and a plan to eliminate income taxes for seniors earning under \$50,000.<sup>1</sup>

Taken together, the Tax Foundation estimates the McCain proposals would increase the number of nonpayers by about 15 million, bringing the total number of taxpayers who pay no personal income taxes to 62 million, roughly 43 percent of all tax filers. Almost all of this is due to McCain's health care credit, which dramatically realigns health care incentives and gives people a powerful motive to buy health insurance. This tax provision has a bigger impact on cutting people's taxes than any single proposal from either party.<sup>2</sup>

Obama uses a longer list of smaller tax credit ideas to reduce a similar number of taxpayers' liability to zero. About 16 million people who are currently paying at least a little income tax would see their liability zeroed out, bringing the total to 63 million, or 44 percent of all tax returns.

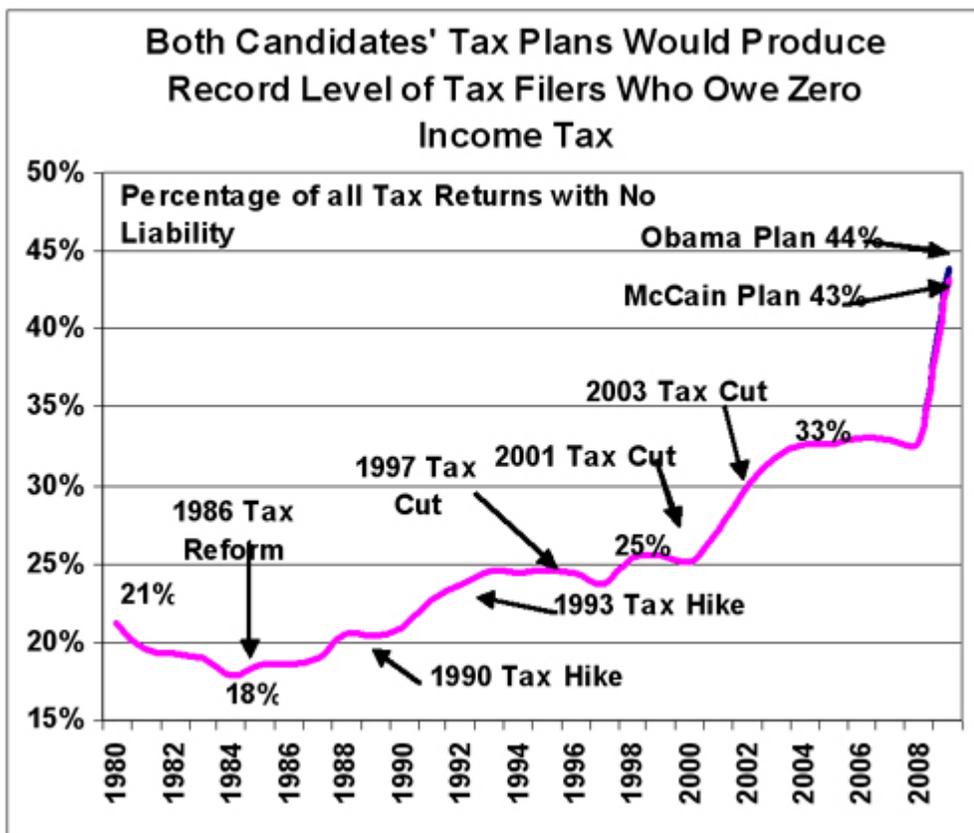
**Table 1.**  
**Impact of Candidates' Tax Plans on the Number of Nonpayers**

	<b>Number of Filers with Zero Tax Liability in 2009 (Millions)</b>	<b>Percentage of All Filers with No Liability</b>
Current Law	47	33%
Obama Plan	63	44%
McCain Plan	62	43%

The chart below shows that major structural tax changes enacted during the 1980s contributed greatly to the doubling of nonpayers. Perhaps the most significant was indexing the tax brackets in 1985 to prevent inflation from pushing people into higher tax brackets. Also, the

Tax Reform Act of 1986 nearly doubled the personal exemption and replaced the zero-bracket with the basic standard deduction for nonitemizers.

Since the early 1990s, however, lawmakers have increasingly used the tax code instead of government spending programs to funnel money to groups of people they want to reward. Credits have been enacted to subsidize families with children, college students, and purchasers of hybrid cars, just to name a few of the most well known. In terms of tax revenue, the most significant of these socially targeted credits was the \$500 per-child tax credit enacted in 1997. The 2001 and 2003 tax bills doubled the value of the credit to \$1,000 and added a refundable component.



Quite aside from the fact that these refundable credits remove millions from the roster of Americans who support the government by paying the income tax, these credits have some undesirable effects.

- **Added complexity.** The explosion of tax credits has added a tremendous amount of complexity to the tax code, especially for low-income Americans who are the supposed beneficiaries of the programs. The EITC is so complicated that more than three-quarters of those claiming it pay a tax preparer to complete their forms.<sup>3</sup>
- **Punitive marginal tax rates.** To withhold the benefit of these credits from "rich people," the definition of which changes from law to law, each of these credits has a phase-out range—that is, a range of income where the taxpayer has to pay back the credit that he no longer qualifies for. As a result, taxpayers in the phase-out range face

unexpectedly high effective marginal tax rates, in effect a severe tax penalty for every new dollar of income they earn. The President's Tax Reform Panel found that taxpayers in the phase-out range of the EITC face a higher effective marginal tax rate than even the most affluent Americans.

- **Narrowing the tax base makes revenue volatile.** Expanding existing credits or adding new ones pushes people who used to pay taxes into the nonpayer range, shrinking the tax base and requiring higher taxes on everyone else. Undesirable volatility in federal revenue is the likely result, as the incomes of higher-income taxpayers include more business, dividend, and capital gains income which fluctuate much more wildly than wages. California has been a case study of this rollercoaster budget problem. The state receives 84 percent of its income tax revenue from taxpayers earning more than \$100,000 annually, and its 66 percent drop in income from stock options and capital gains between 2000 and 2002 contributed to a \$10 billion-plus budget gap.<sup>4</sup>
- **Expanding the role of the IRS.** By most accounts, the task of the Internal Revenue Service is to administer the nation's tax code and collect the expected amount of taxes the system is supposed to raise to fund government programs. Should the IRS also be required to administer all the subsidies that Congress enacts? Collectively, these credits have made the tax code impenetrable for taxpayers and far more difficult for the IRS to administer.

## Conclusion

Over the past two decades, lawmakers have increasingly turned to the tax system rather than direct spending programs to funnel money to targeted groups of Americans, furthering some social or political goal. As a result, millions of Americans have been effectively removed from the income tax payment system while the tax code has been made more complicated to comply with and more difficult to administer. The tax plans of both the presidential candidates would exacerbate this situation greatly.

It is time for a serious public discussion of whether it is desirable to have so many Americans disconnected from the cost of government and what the consequences are of using the tax system as a vehicle for social policy.

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## Notes

1. For the complete list see: Robert Carroll, "Senator McCain's and Senator Obama's Tax Plans: Different Roads Taken," *Tax Foundation Fiscal Fact*, No. 137, August 15, 2008.

2. For more detail on how the McCain health care plan works, see: Robert Carroll, "McCain's Health Credit: Intersection of Health Policy and Tax Policy," *Tax Foundation Fiscal Fact No. 144*, September 16, 2008.

3. "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," The President's Advisory Panel on Federal Tax Reform, November 2005, p. 3.

4. Annette Nellen, "Personal Income Tax Weakness & Possible Remedies: Volatility is too Great," California's Tax System - Report #3A, July 2007.

[http://www.cob.sjsu.edu/nellen\\_a/TaxReform/Report3a\\_21stCenturyTaxation\\_Volatility.htm](http://www.cob.sjsu.edu/nellen_a/TaxReform/Report3a_21stCenturyTaxation_Volatility.htm).

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