Spring 2007

Tax Watch

TAX FOUNDATION
Since 1937

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Who Wins and Loses from Government Tax and Spending Policy?

Most Americans are aware that the nation's tax burden falls most heavily on upper-income households. But what's often ignored is who benefits—and who doesn't—from the way those tax dollars are spent.

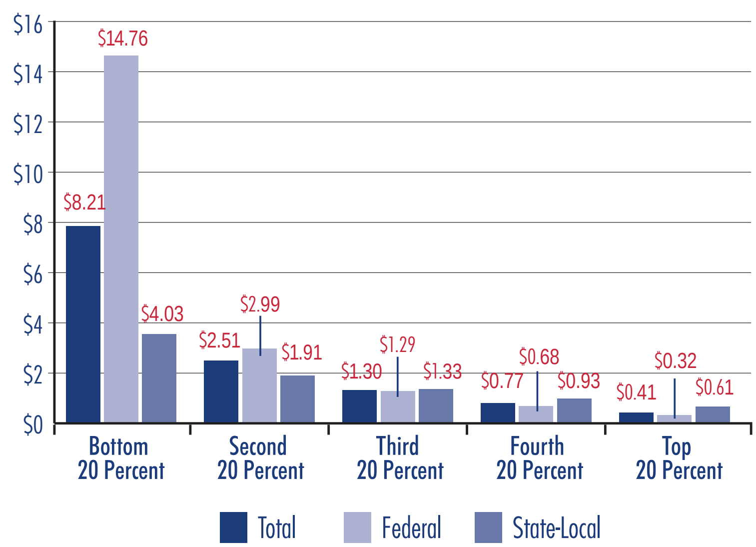
Just as taxes don't fall equally on taxpayers, many government spending programs benefit some Americans much more than others. When all taxes and government spending benefits are counted, which Americans benefit most from tax and spending policies?

According to a forthcoming study by the Tax Foundation, the results may surprise you. Overall, lower-income Americans not only are taxed at a lower rate than the wealthy, but they benefit more on average from government spending than those with the highest incomes.

The study analyzes the distribution of all federal, state and local taxes and spending in the United States. It found that American households with income in the lowest fifth received $8.21 of spending benefits for every dollar paid in taxes in 2004, while the wealthiest fifth received just 41 cents.

Taken together, the bottom three-fifths of income earners—containing roughly 76 million households—receive more dollars of government spending than they pay in taxes, resulting in a net fiscal redistribution of between $1 trillion and $1.5 trillion in 2004.

Dollars of Government Spending Received Per Dollar of Taxes Paid



Tax Burdens and Spending Benefits

The results of the study, which looked at federal, state and local tax and spending data from 1991 to 2004, demonstrate that not only are America's tax polices progressive, or "pro-poor," but overall fiscal progressivity is augmented when one considers government spending as well.

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TaxWatch

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TAX FOUNDATION Since 1937

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Message from the President:

Married Couples with Children No Longer In "Middle Class"

In January, the House Ways and Means Committee held a hearing on the economic challenges facing the "middle class" to investigate the notion that today's families are experiencing economic pressures greater than those faced by their parents' or grandparents' generations.

To understand this issue, however, it is important to recognize how different today's families are from those of 40 or 50 years ago and how demographic changes have affected notions of who is "middle class" and who is "upper income" in America.

If by "middle class" we mean intact families with children—the stereotypical family of four—then these families no longer comprise the majority of the statistical middle 20 percent of taxpayers. The majority of families with children now populate the wealthiest 40 percent of Americans, in part because of the growth in dual-earner households.

In 1960, back in "Leave it to Beaver" days, nearly 70 percent of middle-income households were married couples and most were raising children. Indeed, in 1960, married couples comprised the majority of every group of taxpayers except for the lowest 20 percent. Of that low-income group, 73 percent were single filers.

Over the past four decades, demographic changes have dramatically altered the picture of the statistical middle and contributed to the perception of widening income disparity in America. But three things are immediately clear about today's society.

One, there are vastly more single taxpayers than ever before and they comprise the majority of the populations of the first three quintiles. Two, because of the rise in dual-earner families, married couples are mostly found in the two highest quintiles. Three, a greater percentage of taxpayers in the top two-fifths of income are married couples without dependents; no doubt many are "empty-nest" Baby Boomers nearing their peak earning years.

Today, the composition of taxpayers in the statistical "middle class" is completely reversed from what it was in 1960. More than two thirds of modern middle-income taxpayers are single, or single-headed households, while just 36 percent are married. More dramatically, while half of the middle-income taxpayers in 1960 were couples with children, today only 18 percent of these taxpayers are couples with children. The majority of couples with children are now clustered in the top two fifths.

These demographic shifts have no doubt contributed to the perception of rising income inequality. When the so-called rich are increasingly couples with two incomes, they will naturally look wealthier than the vast number of single taxpayers who now populate the statistical middle.

As has been outlined in previous Tax Foundation studies, taxes are stressing these dual-earner families from all sides. As lawmakers look for solutions to the economic challenges facing today's "middle-class" but upper-income families, they would do well to consider the way in which taxes—federal and state-local—are contributing to the problem.

Sincerely,

Scott A. Hodge
President

Some Congressional Districts Hit Hard by AMT

A key issue facing the new Congress is whether to reform—or repeal—the Alternative Minimum Tax (AMT). But a recent analysis by the Tax Foundation shows that not all lawmakers' congressional districts are equally affected.

"The AMT was originally designed as a backstop for the federal income tax, and affected only a small number of wealthy taxpayers," said Andrew Chamberlain, co-author of the analysis. "But its reach has grown in recent years, and it has begun drawing in middle- and upper-middle income taxpayers as well."

In 2000, just 1.3 million tax returns were subject to the AMT. If left unreformed, the Joint Committee on Taxation estimates the number of AMT returns will spike to 19 million in 2006, reaching a peak of 29 million in 2010—nearly 20 percent of all tax filers—before tapering off sharply. As a result, reforming the AMT has become a key legislative priority for many Members of Congress.

"A confluence of factors is pushing more and more Americans into the AMT system," said Gerald Prante, co-author of the Tax Foundation study. "Not the least of which has been the Bush tax cuts, which have significantly reduced taxes for all taxpayers."

> *"A confluence of factors is pushing more and more Americans into the AMT system."*

Wealthy States Hit Hardest

Congressional districts in New York, New Jersey and California dominate the list of areas most affected by the AMT. New York's 18th congressional district, comprising the Westchester suburbs of New York City, tops the list with 13.5 percent of all tax returns subject to the AMT. Overall, nine New York congressional districts appear in the top 20, while California and New Jersey each have four, and Connecticut, Illinois and Maryland each have one.

Congressional districts in Alabama, Tennessee and Texas dominate the list of least affected areas. Texas's 29th congressional district, which covers north Houston, is the nation's least affected district, with just 0.28 percent of all tax returns subject to the AMT. Overall, four districts in Alabama, Tennessee and Texas appear in the bottom 20, while Arizona and Missouri have two districts, and Kentucky, Oklahoma, Mississippi and Florida each have one.

The factors that push taxpayers into the AMT are more prevalent in some areas than others, so it is not surprising that some congressional districts are more heavily affected by the AMT.

The AMT is a parallel tax code to the ordinary federal income tax, so that when filing tax returns each April taxpayers must calculate their liability under both systems and pay whichever amount is highest. As a result, anything that decreases ordinary income tax bills or increases AMT tax bills pushes more taxpayers into the AMT.

State and local taxes are federally tax-deductible, and therefore taxpayers living in congressional districts with high state and local taxes will be harder hit by the AMT. Because the regular income tax allows a personal- and dependent-exemption deduction, congressional districts with more dependent children are therefore more likely to be affected by the AMT. Also, urban congressional districts with relatively high incomes are much more likely to be affected by the AMT.

"As the new Congress debates what to do about reforming the AMT, it will be interesting to watch how lawmakers' stances are affected by this geography," said Prante.

To read the full analysis, "IRS Data Reveal Some Congressional Districts Hit Harder by Alternative Minimum Tax (AMT) than Others," visit www.taxfoundation.org.

Tax Fact:

Cities with highest federal income tax burden in 2004: Stamford-Norwalk, CT; Naples, FL; San Francisco, CA.

Gross Receipts Taxes: Bad Policy Prescription for States

"No sensible case can be made for imposing gross receipts taxes in the modern economic environment."

Gross receipts taxes violate basic principles of good business tax policy and should be avoided by state lawmakers debating tax reform, according to a new study published by the Tax Foundation and the Council on State Taxation (COST).

The in-depth Background Paper, written by Professor John Mikesell of Indiana University, provides a history of gross receipts taxes, which date back to the thirteenth century, and argues against their re-emergence.

"No sensible case can be made for imposing gross receipts taxes in the modern economic environment," Mikesell concludes. "Gross receipts taxes should never be seen as an element of positive tax reform. They were abandoned for good reason."

Gross receipts taxes are levied on the full value of each business transaction during the chain of production, from the time a resource is extracted to the time it becomes a product for sale. Unlike other business taxes, the taxable amount is not adjusted for business costs.

According to the report, gross receipts taxes violate key principles of taxation such as transparency, simplicity and neutrality. The result creates a hidden tax on consumers buried in the price of the product. Gross receipts taxes promote distortions in the market that cause businesses to make inefficient decisions to avoid higher taxes, according to the study.

"Businesses never represent the final resting place of the tax burden, but rather serve as a conduit of the tax burden to households, either through higher prices paid for goods,... lower returns received from the sale of services... or through reduced net returns to business owners," Mikesell argues. "A tax that distorts the functioning of the market is a loss for everyone; any special advantage from the distortion is less than the loss incurred by the rest of the economy."

A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world, the report argues. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase goods from outside the state.

Mikesell acknowledges that taxing private business is appropriate and that "it is logical for businesses to pay for the public services that allow them to protect their operations, to prosper financially, and to grow." But lawmakers must also understand that businesses will always pass on the costs of doing business to consumers, employees, and shareholders.

In other words, businesses don't pay taxes any more than a plot of land pays property taxes. Ultimately, people have to pay. The method of taxation should allow taxpayers to be aware of the tax and understand what is being taxed, and should treat all taxpayers the same.

The gross receipts tax base can be broad, but it lacks any link either to capacity of taxpayers to bear the cost of government services or to the amount of government services used by them—the two usual standards for assigning tax burdens.

The report advises state lawmakers approaching tax reform that rather than designing policy to tax business, a more useful approach is to recognize the role of business as a conduit to households and to structure taxes accordingly.

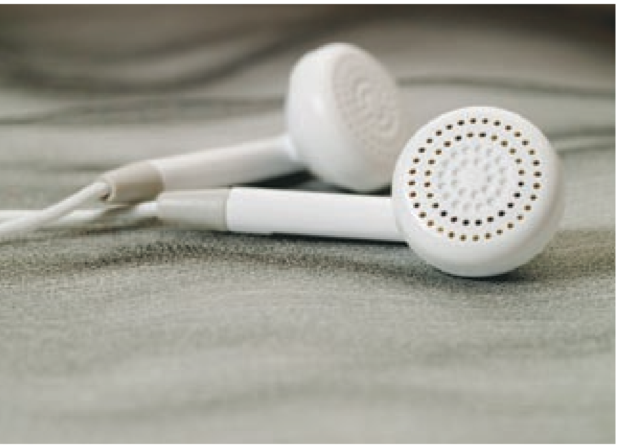
Read the full report, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," online at www.taxfoundation.org.

Experts Talk Tax Reform in Recent Tax Policy Podcasts

Washington's most influential thinkers, government officials, and journalists are among the recent guests of the Tax Foundation's weekly audio podcast.

In just the past few months, Tax Policy Podcast guests have included Wall Street Journal columnist John Fund, Harvard Business School professor Mihir Desai, and Katherine Baicker of President Bush's Council of Economic Advisers.

In a January interview, Fund suggested that the new Congress focus on reforming the tax code to make it easier for Americans to save and invest as they plan for the future.



He called the current tax system "irredeemably broken" and blamed what he called the "Appropriations Party" for reversing the major reforms of 1986.

"We've had 15,000 changes in the tax code [since 1986]. The tax code is even more bulky and out of control than ever," he said.

"Now, we probably can't go nearly as far as 1986 but I think there are going to be some Democrats who recognize that in the long run the real tension in their party is going to be between the people who want to just, you know, have a bidding war with K Street lobbyists for changes and favors in the tax code and those Democrats who recognize that the way to have economic growth, which means more money for social programs, is to streamline and simplify the tax code."

> *"We've had 15,000 changes in the tax code [since 1986]. The tax code is even more bulky and out of control than ever..."*

Taxes Matter to Business

Desai spoke about how major a concern taxes are to businesses when they make decisions such as where to locate, on repatriation of profits, and how they organize.

"Taxes are, in fact, a first order of concern for firms when they make a variety of decisions," he said. Foreign direct investment "is much more about a global production process where cost factors, especially taxes, are central."

Desai said the corporate tax system needs reform in order to remove disincentives to realizing capital gains and should use a global perspective in considering the effective rate of taxation on companies.

"It's impossible to think about corporate taxes without thinking about the international provisions," he said. "And those international provisions are highly complex, highly burdensome, and actually may put American firms at a disadvantage when they compete to buy assets around the world."

Taxes and Health Care

During her podcast, Baicker argued that tax deductions for health insurance would even out inequities in the tax code and help drive down costs.

"The current system...has these biases built in," said Baicker, a member of the CEA since 2005. "People who get insurance through their jobs get a tax subsidy," but those who pay for private insurance do not get the tax break, she explained.

She said the plan President Bush announced in his 2007 State of the Union speech seeks to "level the playing field" by allowing those who pay for private insurance on their own to receive the same tax advantage as those who claim health insurance through their employers.

"Part of the reason that health care costs are spiraling out of control is that the tax code is pushing people into insurance policies that increasingly cover care of marginal value," Baicker explained.

Listen to our full Tax Policy Podcasts online at www.taxfoundation.org/podcast/.

Tax Fact:

Number of corporate income tax rates in 1974: 2. Today: 8.

Tax Burdens and Spending Benefits (continued from page 1)

> *"Not only are America's tax polices progressive, but overall fiscal progressivity is much greater when government spending is considered as well."*

Furthermore, the data show that these distributional effects have grown since 1991.

The new study represents the second phase of the Putting a Face on America's Tax Returns project, which is a centerpiece of the Tax Foundation's research agenda. It is a seminal effort to examining the demographic changes that are effecting the distribution of incomes and tax burdens in America.

"Just as taxes fall more heavily on some households than others, government spending clearly does not benefit households equally," said economist Andrew Chamberlain, co-author of the new study.

Transfer programs such as aid to needy families, veteran's benefits and Social Security explicitly target particular groups and not others, while even spending designed to provide general benefits, such as funding for public universities, airports and highways, routinely benefits some households more than others.

"The ratio of federal government spending received to federal taxes paid is much more pro-poor than for state and local spending and taxes," said economist Gerald Prante, co-author of the new study.

Households in the bottom fifth received $14.76 of federal spending per dollar of federal taxes, compared to $1.29 for the middle fifth and 32 cents for the top fifth. In contrast, households in the lowest fifth received just $4.03 in state and local spending per dollar of state and local taxes, while households in the middle fifth received $1.33 and households in the top fifth received 61 cents.

When items such as national defense, environmental protection and courts are excluded, only the bottom two fifths receive more government spending benefits than they pay in taxes. Households in the bottom fifth receive $6.33 in government spending benefits per dollar of taxes paid. Households in the middle fifth receive 92 cents, while households in the top fifth receive just 31 cents per dollar of taxes paid.

On a net basis, households in the bottom fifth receive an average of $31,185 more in total spending than they pay in taxes, while households in the middle fifth receive $6,427 more in spending than taxes. In contrast, households at the fourth highest income level receive negative net benefits, paying $8,091 more dollars in total taxes than they receive in spending. Households in the top fifth receive the fewest dollars of spending relative to tax burdens, paying $48,449 more in taxes on average than they receive in government spending.

Growing Fiscal Redistribution

Looking at the data since 1991, while the tax share of households in the lowest fifth has remained unchanged, their share of government spending has risen from 28.3 percent to 30.4 percent, representing an increase of $76.1 billion, or $2,506 per household, by 2004. In contrast, the share of spending received by households in the top fifth fell from 19.5 percent in 1991 to 17.2 percent in 2004.

"The common practice among politicians of measuring only tax progressivity clearly understates the true level of progressivity, giving lawmakers a distorted view of the equity of existing government policy," said Chamberlain.

Two recent trends have reinforced the deficiencies of measuring tax distributions. First is the rapid growth of tax expenditures and targeted tax credits in recent decades, which has blurred many traditional lines between taxes and spending by using the tax system to implement social and economic policy. Secondly, lawmakers in coming decades face a looming crisis of growing entitlement spending that will require difficult choices for both tax and spending policies.

"Lawmakers should not rely on tax distributions alone when judging the equity of policy changes," said Chamberlain. "Instead, they should consider the impact of both tax and spending policies in tandem."

Read the full report, "Who Pays U.S. Tax Burdens, and Who Receives Government Spending Benefits?" online at www.taxfoundation.org.

Making Taxes Simple: Life, Death and Estate Taxes

Economists teach that a bad tax is one that changes peoples' behavior for the worse. In this respect, there is no tax with more striking moral consequences than estate and gift taxes, which may force families to make life and death decisions while millions of dollars of tax liabilities hang in the balance.

A new study of death rates following the repeal of Australia's estate tax in 1979 provides some eye-opening evidence of this. The study, conducted for Australian National University's Centre for Economic Policy Research, analyzed daily death statistics in the days before and after the repeal of the estate tax. Researchers found that 50 deaths shifted from the week before the abolition to the week after.

The study highlights the need to repair the flaws in our own estate tax. The current federal estate tax is scheduled to disappear for year 2010, but will return on January 1, 2011 at 2001 rates and exemption levels.

It's easy to see the shocking economic incentives that creates. Under current law if a sick or elderly family member dies December 31, 2010 they pay zero estate tax. But if they live one additional day, they pay estate tax rates of up to 50 percent.

To non-economists, this idea that estate taxes can affect moral decisions seems implausible. But there's a surprising amount of evidence that death and taxes may be linked in more ways than one.

For more information about estate taxes, visit us online at www.taxfoundation.org/research/topic/99.html

Tax Foundation in the News

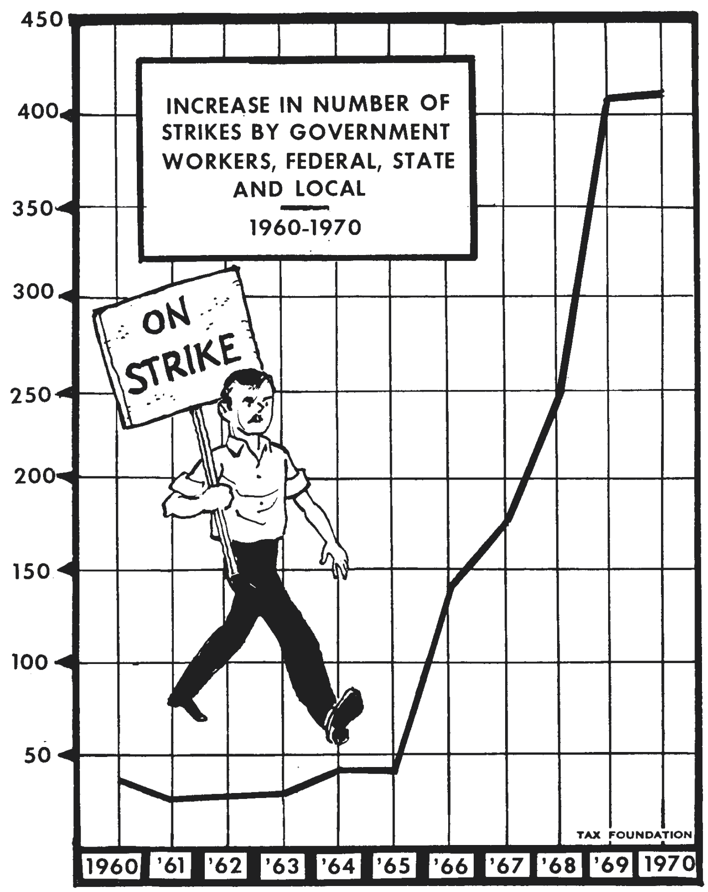
If there is any hope of convincing lawmakers to pursue efficient tax policy and steer clear of wrong-headed tax decisions that could hamper economic performance, it's important that the public has a better understanding of what makes good tax policy. Fortunately, the Tax Foundation continues to be an influential voice, with our research making regular appearances in newspapers, on television, and on radio.

In January alone, the Tax Foundation was cited 68 times in print, translating into over two mentions per day in major newspapers such as *USA Today*, the *Washington Post*, the *New York Post*, the *New York Sun*, the *Atlanta Journal Constitution*, and the *Philadelphia Inquirer*. Of the 68 mentions, 24 were in editorials or op-eds and 18 referenced a Tax Foundation study on property taxes. The report by Gerald Prante found that property tax collections have exploded over the past four years. The *Detroit News* published a commentary by staff attorney Chris Atkins and economist Jonathan Williams warning Michigan residents about the dangers of instituting a gross receipts tax.

In addition to appearances in print, the Tax Foundation was cited by broadcast networks including CNN, CNBC, and C-SPAN. It was also mentioned by three radio stations.

View more media hits online at www.taxfoundation.org/press/.

From the Archives: 1972



Support the Tax Foundation

Since 1937, the Tax Foundation has monitored America's tax policies, and our research and educational efforts on the economic impact of government policy have stood the test of time. Our annual calculation of Tax Freedom Day® remains one of the most widely used tools for illustrating America's tax burden to media professionals, legislators, and—most importantly—taxpayers.

None of this work would be possible without the generosity of our supporters. By making a tax-deductible investment in the Tax Foundation, you become a valuable partner in helping to assure that our research and publications continue to shape sound tax policy in America—for the good of future generations of taxpayers, as well as our own.

Please use the enclosed envelope to send your contribution today, or visit our website at www.taxfoundation.org to make an online contribution. For more information about supporting the Tax Foundation, contact Lisa Hazlett at (202) 464-5110 or hazlett@taxfoundation.org.

Coming Up: Tax Freedom Day 2007

How long will America work to pay the total tax burden this year? Find out from our famous Tax Freedom Day report for 2007. We'll announce this year's Tax Freedom Day on Wednesday, March 28th this year.

Please celebrate Tax Freedom Day with us by visiting our website at www.taxfoundation.org/taxfreedomday/.

Save the Date:

Tax Foundation's 70th Anniversary Dinner

This year marks our 70th year of promoting sound tax policy for America. Please mark your calendars for our upcoming 70th Anniversary Annual Dinner, held on Thursday November 15, 2007 in Washington, D.C.

Please visit our website for details at www.taxfoundation.org/events/, or call Tiffany Bradley at (202) 464-5104.

We hope you'll join us!