TaxWatch

Spring 2009

TAX FOUNDATION Since 1937

America's Tax Freedom Day Arrives Early

The economy may be in recession, but it's not all bad news. Thanks to recent tax cuts and a slowing economy, America's tax burden fell to the lowest level in four decades this year.

That's the finding of the latest Tax Freedom Day® calculation from the Tax Foundation. According to the new report, Americans will work until April 13th in 2009 to pay their federal, state and local tax bills. That's two weeks earlier than 2007, and is the nation's lowest tax burden since just after the Kennedy tax cut in the 1960s.

"This short-term dip in tax burdens is being driven by two factors," said Scott A. Hodge, President of the Tax Foundation. "Falling incomes from the recession have sharply cut tax collections. And the so-called 'stimulus' package recently passed by Congress included significant temporary tax cuts."

The tax cuts in the stimulus bill include the "Making Work Pay" credit, an expanded education credit, and a temporary fix of the growing Alternative Minimum Tax (AMT).

Taxes may be down today, but the study warns of looming budget deficits that threaten to push taxes to unprecedented levels.

"Government spending is expected to explode in 2009," said Josh Barro, Tax Foundation economist and author of the new report. "If this year's projected deficit were counted as a tax, Tax Freedom Day wouldn't arrive until May 29th—the latest date ever for this deficit-inclusive measure."

While taxes are at historic lows, Americans still work nearly three and a half months to pay for government, more than any other expense in the average family budget.

"Despite the economic slowdown, Americans will spend more on taxes this year than on food, clothing and housing combined," said Barro. Overall, the nation's total tax bill is $3.48 billion for 2009, or 28 percent of the nation's income.

America's Rising Tax Burden

For most of the nation's history, America has been a low-tax haven. From the nation's founding through the early part of the 20th century government spending

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TaxWatch

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TAX FOUNDATION Since 1937

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Message from the President:
The Donor Next Door

I was saddened recently to learn that long-time Tax Foundation supporter Austin "Pete" Verity passed away last August at the age of 91 in Vero Beach, Florida. I'd been thinking about Pete after President Obama released his new budget which calls for higher taxes on the so-called "rich." Although Obama wants us to think that taxes on the rich will only impact hedge-fund managers, I know better. They will actually hit millions of successful entrepreneurs like Pete who have become the target of envy and redistributive politics.

To me, Pete Verity symbolized the American dream. When he returned to Long Island, New York, after serving in the Army during World War II, he had nothing but a strong back and an old truck that his father had once used to run bootleg liquor. Making do with what he had, he started a small moving company called Austin Verity & Son Inc. in Seaford, Long Island.

As time went on, Pete's small local company started moving retirees from Long Island to Florida. This was back in the day when people were literally buying retirement homes in the proverbial swamp. In some cases, Pete's moving trucks had to drive miles out of their way because the wooden bridges serving many areas of Florida at the time could not bear the weight of a full moving van.

In 1991, after moving thousands of people to Florida, Pete and his wife Dorothy retired there themselves. They lived modestly and I'm sure never considered themselves rich. They were the classic "millionaire next door." Pete told me that he contributed to the Tax Foundation because we were defending the values that he had worked his whole life to uphold. I have never felt a greater burden than I did that day.

As I have traveled the country getting to know hundreds of Tax Foundation supporters such as Pete Verity, I have learned that the key to financial success is to start and run your own business. Yes, some people do get rich by winning the lottery or by being talented enough to become professional athletes. But the vast majority of successful Americans do it the old-fashioned way—they invent a product or service that other Americans need or want. Then they work 80-hour weeks to build the business into something bigger than themselves.

While demagogues will defend the higher taxes by saying that "only 2 percent of all small businesses will pay higher taxes," the reality is that the majority of taxpayers who will be hit by the higher tax rates are business owners. The so-called rich are America's entrepreneurial class and tend to pay their business taxes with their individual tax form, not a traditional corporate form.

Tax Foundation economists estimate that more than half of all small business income could face higher taxes if Obama's tax hike is allowed to be enacted. This could be the largest tax hike on entrepreneurship in American history. That is not the change America deserves.

So to Pete Verity I say goodbye and thank you. We will continue to defend the values that you exemplified all your life.

Sincerely,

Scott A. Hodge

Federal Tax Reform on the Way?

With Obama's creation of a new tax reform panel this spring, federal tax reform is making headlines again. Just in time, a new Tax Foundation study outlines a bipartisan way to overhaul America's complex and burdensome tax code.

"Federal policymakers face a choice: they can either continue to operate in a 'reactive' mode, proposing tax legislation haphazardly, resorting to temporary fixes, and acting hastily when tax legislation is due to expire," said the authors, "or they can take a 'proactive' stance, instituting farsighted reforms that will lead to an efficient and fair tax system for the long term."

The study is authored by four leading tax experts from diverse backgrounds: Dr. Robert Carroll of the Tax Foundation, Diane Lim Rogers and Buck Chapoton of the Concord Coalition, and Maya MacGuineas of the Committee for a Responsible Federal Budget.

> *"The federal tax code is inefficient and not ready for the 21st century economy."*

The report presents a reasonable, consensus approach to tax policy that highlights areas of agreement among experts across the political spectrum.

"We believe a productive discussion of tax reform starts where tax and budget policy considerations intersect," said the authors. "The approach we have laid out can serve as an excellent starting point for developing a comprehensive, bipartisan proposal that would vastly improve our tax system."

Getting Real Stimulus

In the midst of debates over "stimulating" the economy, the authors warn that some kinds of stimulus spending may end up hurting the economy in the long run.

"When it comes to tax policies pursued in the name of short-term stimulus, the rule should be 'first, do no harm,'" said the authors. Economic stimulus should be fiscally responsible and not simply shift burdens to future generations through deficits.

The authors urge lawmakers to return to basic tax principles: broad tax bases, lower tax rates, cutting economic distortions from the tax code, encouraging savings, and making taxes more transparent.

One key recommendation is to broaden the tax base and cut rates for the personal income tax. The study shows that credits, deductions and exemptions carve away nearly 45 percent of the income tax base, requiring much higher rates. Eliminating them would allow a 34 percent across-the-board tax rate cut.

"Credits and deductions shrink the size of the tax base, and many of them accrue disproportionately to higher-income individuals, and require higher tax rates generally to raise the same amount of revenue," said the authors.

With America's corporate tax rates among the highest in the world, the study calls for a wholesale revision of the corporate tax code.

"Corporate tax rates have the effect of reducing capital accumulation, lowering labor productivity and ultimately real wages and living standards," said the authors. "The lesson is that the United States should place less emphasis on business income taxes for financing government."

The authors of the study have different views on the appropriate size and scope of government, but they agree on one thing: the current federal tax code is deeply flawed and ripe for fundamental reform.

"Today's tax code raises revenue inefficiently, and is not well equipped to handle the challenges of the 21st century economy," said the authors.

Read the full study, "Moving Forward with Bipartisan Tax Policy," at www.taxfoundation.org/research/show/24335.html.

Tax Fact:

America's highest state government spending per capita: Alaska, $13,508 per year.

State Budget Shortfalls May Spark Tax Reform

> *"Broadening tax bases and lowering rates can generate extra revenue while improving tax systems."*

While most states facing budget crises are seeking tax hikes and federal bailouts, a new Tax Foundation study highlights opportunities for much-needed state tax reform.

"Budget squeezes are tough times for lawmakers, but also offer an opportunity to reexamine flawed state tax codes," said Joseph Henchman, Director of State Projects at the Tax Foundation. "In a time of budget shortfalls, broadening tax bases and lowering rates can generate extra revenue while improving the simplicity, transparency and neutrality of state tax codes."

As the economy lingers in recession, 45 states face budget shortfalls totaling $132 billion through 2010. However, the hardest-hit states are those with poorly-designed tax codes.

"The most severe budget shortfalls are occurring in states with taxes that rely heavily on unstable revenue sources like taxes on capital gains, high-income earners, and corporate profits," said Henchman.

Many states have responded to budget shortfalls by proposing new punitive taxes on unpopular groups like smokers, drinkers and high-income earners. But the study warns against this predatory approach to tax policy.

"Shifting tax burdens onto unpopular taxpayers may be politically safe, but it risks further distorting economic incentives, invites retaliation from other states, and ultimately harms economic activity and commerce," said Henchman. The study argues that shifting tax burdens onto narrow groups may also encourage wasteful spending, as it further separates the cost of government from those demanding services.

The "Washington Monument" Ploy

A popular tactic used by governments to shield themselves from budget cuts is the so-called "Washington Monument" ploy. Under this approach, officials warn that budget cuts will force the elimination of popular government programs first. The name comes from the U.S. Park Service's successful efforts to prevent budget cuts in the mid-1990s by threatening to reduce operating hours at the Washington Monument.

"The intention of the Washington Monument ploy is not actually to close those popular programs, but to generate public opposition to spending cuts and public support for tax increases," said Henchman.

The school system in Detroit employed a particularly egregious Washington Monument ploy this year, announcing that budget cuts will require parents to buy toilet paper for city schools. Another comes from Michigan's Department of Human Services which warned that budget cuts would close food banks or cut money for burials for the dead.

The study outlines several pro-growth alternatives for lawmakers looking to respond to budget shortfalls while also improving state tax codes.

"The Tax Foundation's *State Business Tax Climate Index* offers lawmakers a concrete roadmap for improving state tax systems," said Henchman. The *Index* ranks each state on how well its tax system complies with sound tax principles of simplicity, neutrality, transparency, stability and growth promotion.

The report singles out two recommendations for lawmakers: eliminating tax preferences and using the resulting revenue to finance across-the-board tax cuts, and ending reliance on unstable taxes on capital gains, high-income taxpayers, and corporate income taxes.

"Revenue from capital gains and corporate profits always spikes during economic booms, but plummets during economic busts," said Henchman. "States without spending controls inevitably get themselves into trouble by assuming these windfall revenues will continue indefinitely."

Read the full study, "State Budget Shortfalls Present a Tax Reform Opportunity," at www.taxfoundation.org/publications/show/24321.html.

Tax Fact:

America's highest state income tax burden per capita: Connecticut, $1,811 per year.

Experts Talk Stimulus, Reform in Recent Tax Policy Podcasts

Some of the nation's top experts appeared this spring on the Tax Policy Podcast, discussing topics from entitlement reform to the politics of Obama's stimulus spending.

Barro on Stimulus

In February the Tax Foundation interviewed Robert Barro, Professor of Economics at Harvard University, about the recently passed federal stimulus package. Barro criticized the bill as a "terrible piece of legislation," calling instead for permanent changes to the tax code to spur economic growth.

"What they call tax reductions in this bill are really transfer payments, particularly redistribution of income from the rich to the poor," said Barro.

Barro pointed to the 2003 tax cut legislation as being very positive for economic growth, and chided the current administration for blaming those policies for the current economic downturn.

"The economy did very well for the next several years after the tax cuts of 2003. And it's very unfair that Obama has blamed that program for part of the current financial collapse," Barro said. "There's really no linkage between the tax rate cutting program of 2003 and the financial and housing collapse we've seen in recent months."

> "Eliminating the corporate income tax at the federal level would be a very positive reform."

Barro also suggested ways lawmakers can improve America's long-term economic health.

"Abolishing the corporate income tax at the federal level I think would be very positive. It's a very poor form of taxation," said Barro.

Ryan on Entitlement Reform

In March the Tax Foundation interviewed Congressman Paul Ryan, ranking Republican on the House Budget Committee, about his plans for sweeping reform of federal tax, monetary and entitlement policies.

Ryan has proposed a two-tiered individual income tax system with the top marginal tax rate cut to 25 percent and the lower bracket cut to 10 percent for the first $100,000 for couples. He would also cut the top corporate tax rate to 25 percent.

"Cutting the corporate tax rate would be a fairly modest reform, in my opinion, because that would basically keep us in line with the average international tax rates for industrialized countries," said Ryan. "Raising taxes on individuals, which raises taxes on small businesses, and taxing capital more is not going to help us get investment flowing in this country again."

Ryan also criticized the Federal Reserve's "easy-money policy" that helped fuel the housing bubble and contributed to the current economic downturn.

"We are on a real monetary policy roller coaster," Ryan said. "And I think we need to bring a little more certainty, a little more predictability, to our monetary policy."

Harsanyi on Politics

In March the Tax Foundation interviewed David Harsanyi, columnist for the *Denver Post,* about the politics of the Obama administration's proposed budget.

With the economy in recession, Harsanyi argued that while most "presidents helped ease us out of these tough spots by easing the burden on Americans," the tax provisions in the budget show that "Obama has engaged in the opposite."

In March, Harsanyi published a column questioning whether Obama's policies have helped or hurt the economy.

"The Dow Jones Industrial Average actually has reacted to Obama by plunging nearly 20 percent since he became president," said Harsanyi. "That's an obliteration of wealth that no stimulus bill will recoup."

Listen to the Tax Policy Podcast online at www.taxfoundation.org/podcast/.

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at all levels rarely exceeded 10 percent of the nation's income, and even then only during wartime.

In 1900, Americans paid just 5.9 percent of their income in taxes, and Tax Freedom Day arrived on January 22nd. When Supreme Court Justice Oliver Wendell Holmes made his famous observation that "taxes are what we pay for civilized society" in 1927, the tax burden had grown to just 10.6 percent of income, with Tax Freedom Day arriving in early February.

With the onset of the Great Depression in the 1930s, America experienced its first massive government expansion. By 1933, Tax Freedom Day was pushed back to March. And with the onset of World War II in the 1940s, higher spending pushed Tax Freedom Day into April for the first time.

In 1960, Tax Freedom Day hovered at April 11th. The Kennedy tax cuts helped push the date forward to April 9th in 1964, but Lyndon B. Johnson's "Great Society" quickly reversed the trend and added 15 days to Tax Freedom Day.

By 1981, Americans worked until April 24th for taxes—the latest date ever to that point. The Reagan tax cuts and various property tax limitations sparked by California's Proposition 13 pushed Tax Freedom Day up to April 17th by 1984. But a surging economy and payroll tax hike pushed the date back again to April 22nd by 1989.

Tax burdens continued their upward march throughout the Clinton years, and Tax Freedom Day reached the all-time high of May 3rd in 2000.

In the wake of the dot-com recession and two major Bush tax cuts, Tax Freedom Day had fallen to April 16th by 2003, the earliest date in 20 years. The current recession, "stimulus" tax cuts, and increased reliance on deficit spending has cut taxes even further, dropping Tax Freedom Day to this year's 42-year low of April 13th.

"Looming deficits mean Americans should be wary of tax hikes in the coming decade."

An American Concept

The concept of "Tax Freedom Day" was originally developed by Florida businessman Dallas Hostetler in 1948, who trademarked the phrase. In 1971, Hostetler retired and transferred the trademark to the Tax Foundation.

The success of Tax Freedom Day in the United States has sparked worldwide interest in the concept. Today, Tax Freedom Day is calculated by groups in 24 countries around the world, including Brazil, India, Estonia, Germany, France, Australia, the U.K. and many others. Taxpayers around the world rely on Tax Freedom Day as a simple, vivid illustration of their nation's tax burden.

"Taxes are down this year, but looming deficits pose a real danger of significant tax hikes in the coming years," said Hodge.

Read the full study, "America Celebrates Tax Freedom Day," at www.taxfoundation.org/taxfreedomday/.

Free Offer: *Facts & Figures* Pocket Book

The Tax Foundation is pleased to present the 2009 edition of *Facts and Figures: How Does Your State Compare?*, a pocket-size guide comparing the 50 states on three dozen measures of taxes and government spending.

With many states looking to balance budgets with higher taxes, it's more important than ever to be armed with the facts on state finances.

"As state lawmakers look for solutions to fiscal problems, they should be aware that every tax change affects their state's competitive position compared to neighboring states and the world," said Scott A. Hodge, President of the Tax Foundation.

Get your free copy today. Just send an e-mail to publications@taxfoundation.org with your name and mailing address, or download a free PDF copy online at www.taxfoundation.org/publications/.

We're Moving!

Beginning May 1st, the Tax Foundation's new mailing address is:

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Media Impact Report

With a new President, Congress and the start of many state legislative sessions, Tax Foundation experts were cited throughout the popular media this spring:

Television and Radio

Tax Foundation President Scott A. Hodge appeared on Fox News multiple times to discuss corporate taxes and tax progressivity. Staff Economist Josh Barro continued establishing himself as a national expert on state and local tax burdens and tax complexity with several television appearances on CNN. Director of State Projects Joseph Henchman was featured on C-SPAN's *Washington Journal* in December to discuss opportunities for tax reform in states facing budget shortfalls. And Senior Economist Gerald Prante was a frequent guest on various radio stations throughout the nation to discuss local property tax burdens.

Newspapers

Tax Foundation research has enjoyed a surge of citations in the nation's newspapers in recent months. Editorial boards and columnists from the *Wall Street Journal, Denver Post, San Francisco Chronicle, Minneapolis Star-Tribune, Los Angeles Times, New York Post, Orlando Sentinel,* and *Washington Times* have cited our federal and state tax policy studies. Additionally, elected officials in South Carolina, New Jersey and Wisconsin have authored op-eds using Tax Foundation materials. In total, the Tax Foundation has received more than 160 newspaper and magazine citations in the first three months of this year alone.

Learn more about the Tax Foundation's media impact at www.taxfoundation.org/press/.

Center for State Fiscal Policy: Bringing Sound Tax Policy to the States

With many states facing budget shortfalls, the Tax Foundation's state policy team was busy in New York, Illinois, Indiana, Pennsylvania, Maryland and Idaho.

New York: Staff Economist Josh Barro published an analysis of recent tax and fee proposals from New York's Governor David Paterson, concluding the proposals are a "mixed bag" of good and bad policy.

Illinois: Manager of State Relations Tonya Barr and economist Josh Barro met with staff at the Sam Adams Alliance and the Heartland Institute in Chicago. They will also be working with the Illinois Policy Institute to develop a plan for comprehensive Illinois tax reform.

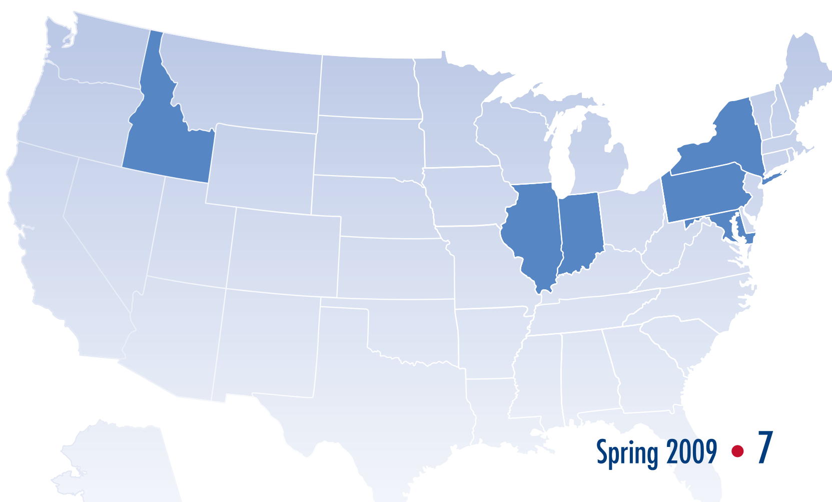
Indiana: Economist Josh Barro and Tonya Barr travelled to South Bend to meet with lawmakers and activists at the St. Joseph County Republican Party. President Scott Hodge spoke at the monthly luncheon of the Economics Club of Indiana and met with Gov. Mitch Daniels and state budget officials.

Pennsylvania: President Scott Hodge gave a presentation on corporate income taxes and the problem of non-payers to the Pittsburgh Technology Council.

Maryland: Economist Josh Barro testified before the House Ways and Means Committee and the Senate Tax and Budget Committee on estate taxes. Tax Counsel Joe Henchman also testified on a bill to require a 3/5 supermajority for tax increases.

Idaho: President Scott Hodge testified on corporate income taxes before the House Committee on Ways and Means. He also met with one of the newest state think tanks, the Idaho Freedom Foundation.

Learn more about the Tax Foundation's Center for State Fiscal Policy at www.taxfoundation.org/research/topic/9.html.



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Why Should You Support the Tax Foundation?

Since 1937 the Tax Foundation has played an essential role in helping educate American taxpayers about the importance of sound tax policy and the role of government. From an intellectual and financial standpoint, our appeal is but to a small segment of society's elite. It is to those few who recognize that tax laws and government budgets are in crisis mode and that now, more than ever before, our leaders need the work of the Tax Foundation to make informed decisions for a better future.

Most nonprofits can emotionally connect to donors with an image of a homeless puppy or a hungry child. However, rescuing animals and feeding children is not our mission. We realize it is difficult to feel passionate about a team of eggheads crunching numbers and analyzing tax policy. But in an indirect sense, if tax reform based on our work promotes business growth and employment, perhaps fewer children will go hungry, or perhaps more families will afford the upkeep of a shelter puppy.

"From an intellectual and financial standpoint, our appeal is but to a small segment of society's elite."

As a Tax Foundation member, you'll enjoy the pride of helping maintain one of the nation's oldest non-partisan, non-profit think tanks. Your generous financial gift helps ensure that our research and publications will continue to shape tax policy in America.

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