

Tax Watch



Homeowners' Burden: Property Taxes on the Rise Across America

One of the best signs of a healthy economy is rising home values. When times are good, renters aspire to become homeowners, and homeowners vie for bigger, newer homes that accommodate their prosperity.

During the economic boom of the 1990s, personal income growth outpaced property tax growth in nearly every year. But since the bursting of the stock market bubble in 2000 and the recession that followed, annual increases in property tax

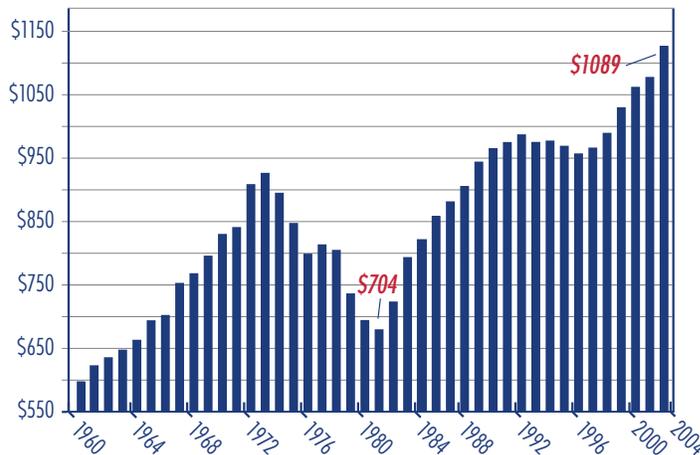
But along with rising home values comes a rise in the hidden cost of homeownership—state and local property taxes.

Polls from the Tax Foundation consistently show property taxes are among the most disliked state and local taxes. Last year, 39 percent of Americans said property taxes were the “least fair” state and local tax, compared to just 20 percent who said income taxes and 18 percent who named sales taxes.

In the wake of the recent housing boom, property taxes have skyrocketed. According to a new Tax Foundation study, property taxes rose to record levels around the country in recent years.

“Property tax collections have grown faster than any other major tax source over the past five years,” said Gerald Prante, an economist who studies property taxes at the Tax Foundation.

America's Rising Property Tax Burden



■ Annual Property Taxes per Person, in Inflation-Adjusted 2004 Dollars

bills have far exceeded peoples' income growth. While personal incomes have grown steadily in recent years, housing prices have exploded.

The new Tax Foundation study found that property taxes were highest in the Northeast, Texas, Illinois, and Wisconsin. New York and New Jersey dominate the list of high-tax counties.

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Message from the President: New Congress Should Call Truce on Tax Credits



After watching Republicans' humiliation over "earmarked" pork-barrel projects like the "Bridge to Nowhere," the new Democratic majority has promised to cut earmarks and make the practice more transparent. But while they're fixing the spending process, they'd do well to call a truce on tax credits aimed at achieving social, political, or economic goals through the tax code as well.

Special tax breaks may not have the sexy appeal of "Fleeing of America," but they are a major factor contributing to the Byzantine complexity of the tax code. Moreover, they steer private resources in the direction that politicians favor, rather than the marketplace. And by carving up the tax base, they force up tax rates on the rest of us, and serve as a roadblock to fundamental tax reform.

The outgoing Republican majority enacted many sound tax provisions since taking control of Congress in 1995, such as reduced capital gains, dividend, and personal income tax rates. But they also enacted some very poor tax measures.

One of these—the Child Tax Credit—was the centerpiece of the 1994 "Contract with America." Enacted with the best of intentions, the tax credit has knocked millions of taxpayers off the tax rolls and deepened the divide between Americans with "skin in the game" and those without. Today, there are more than 43 million households that file a tax return but have no tax liability after they have taken advantage of all of the credits and deductions available to them. That's a 50 percent increase in the number of "nonpayers" since 2000. And many of these households also receive generous cash benefits back through provisions such as the Earned Income Tax Credit.

Because of growing tax credits, the IRS has become an important component of the modern "welfare state," distributing nearly \$50 billion in credits per year.

Republicans have also tried to solve other problems with tax credits. For example, the Energy Policy Act of 2005 authorized \$1.65 billion in tax credits for "clean" coal projects. The IRS and Department of Energy recently announced \$1 billion in tax credits to just nine companies. A total of 49 companies applied for the credits, but the Department of Energy—rather than the marketplace—determined that just nine winners had the right technology to qualify.

In January, the new Democratic majority will take over with their own laundry list of ways they'd like to use the tax code to achieve various goals, including tax breaks for college tuition, bio-fuels, broadband service, and small business health insurance.

Each of these will certainly be popular with voters and, no doubt, will be well-intended. However, because so many Americans today pay zero federal income taxes, it is unlikely that many of those who are targeted will be able to take advantage of the new credits, unless they're made refundable. And if they are, millions more will be taken off the federal tax rolls, potentially expanding the number of nonpayers to half of the U.S. population. And that simply cannot be good for democracy.

Which Americans Benefited from the 2001 and 2003 Tax Relief?

“Despite criticisms of recent tax policy, all income groups have witnessed their federal income tax burdens fall, including lower- and middle-income taxpayers.”

Ever since the Bush tax cuts were enacted in 2001 and 2003, a political debate has raged over whether the benefits of the cuts went to the wealthy or to low-income Americans. But despite the debate, a new study from the Tax Foundation shows that the tax burden has been reduced for all income groups in the United States.

“While it’s true that the wealthy save a higher dollar amount from any across-the-board tax cut because they pay more in taxes,” said Scott Hodge, President of the Tax Foundation, “the latest IRS data show that effective tax rates have fallen for every income group recently.”

A recent Tax Foundation study of the impact of the 2001 and 2003 tax cuts shows that the percentage decrease in tax burden was greatest for those in the lowest income groups between 2000 and 2004.

For example, in 2000 a taxpayer with an adjusted gross income (AGI) of \$35,000 who pays 8.5 percent of his income in federal income taxes would have paid \$2,989 in federal income taxes after credits. After the recent tax cuts, his effective rate fell to just 5.1 percent, and he paid \$1,792 in taxes—a 40 percent decrease in tax burden.

At the other end of the income spectrum, a taxpayer earning \$1.75 million would see his effective tax rate fall from 29.4 percent to 25 percent. Before the tax cuts, he would pay \$513,625 in federal income taxes after credits. Following the tax cuts, he would pay \$437,500. This amounted to a 14.8 percent reduction in tax burden.

The tax cuts have taken many taxpayers in the low-income groups off the tax rolls entirely. In 2000, approximately 32 million tax returns had no income tax. By 2004, that number had risen to around 43 million returns. This is largely because of the expansion of the Child Tax Credit along with the establishment of the 10 percent tax bracket.

In 2004 much more money was returned to low-income earners through the tax code through programs like the Earned Income Tax Credit (EITC) and the Refundable Child Tax Credit than in 2000.

“Among lower- and middle-income groups, many taxpayers receive more back from the IRS than they actually pay in federal income taxes,” said Hodge.

Every AGI group up to \$25,000 actually receives more back from the IRS in the aggregate than it pays in federal income taxes.

Some States Benefit More

Because states have different demographic profiles, some states’ taxpayers benefit more than others from the tax cuts. The states that realized the biggest tax savings as a dollar amount were high-income states: Massachusetts, Washington, Connecticut, California, and New Hampshire.

In terms of percentage savings, the big winners were Mississippi, Louisiana, Washington, Idaho, and Colorado. The smallest percentage cuts were in New Mexico, Maryland, Rhode Island, New York, and Nevada.

Read the full analyses, “New IRS Data Show All Income Groups Have Seen Tax Liabilities Fall Since 2000” and “IRS Data Reveal Which States Benefited Most from 2001 and 2003 Tax Cuts” at www.taxfoundation.org.

Tax Fact:

*Tax Freedom Day in
1900: January 22nd.
Today: April 26th.*



Tax Code Continues Taxing Investors for Inflation

*“The index-
ation of capital
gains for infla-
tion is an issue
that’s good
economics, and
good politics.”*

Democratic and Republican lawmakers don’t always agree when it comes to tax policy. But there’s one step toward tax reform that both parties may be able to agree on in the new Congress—indexing capital gains for inflation.

Regular federal income taxes were indexed for inflation in the 1980s to end so-called “bracket creep.” But taxes on capital gains were not indexed. That means investors often pay taxes on illusory profit caused by inflation, not real gains.

“When Congress indexed income tax brackets for inflation in 1981, it was considered such a daring reform that a four-year delay was built in,” said Curtis Dubay, an economist at the Tax Foundation and author of a new study on capital gains indexation. “But in retrospect, like air conditioning, indexation seems like something we should never have had to live without.”

A new study from the Tax Foundation shows that inflation has influenced the rate of capital gains taxation in wild fashion over the last 50 years. In some years the effective rate has been so much higher than the statutory rate that it mocked the idea of capital gains being taxed at a “preferential rate.” Even now,

after two decades of modest inflation, indexation would be an excellent reform, improving the predictability of tax burdens on capital investment.

The occasional bill has been introduced in Congress to index capital gains. In the outgoing Congress, it was H.R. 6057, sponsored by Representatives Mike Pence (R-IN) and Eric

Cantor (R-VA). Although an unlikely prospect for enactment on its own, such a bill could become part of a fundamental tax reform plan.

The study also found that as a percentage of real capital gains, the average capital gains tax rate on stock has often exceeded the top tax rate on wages. It also found that fixing the problem would not be difficult for Congress.

“Indexing capital gains for inflation on stock imposes no special administrative burden, and lowering the effective rate to equal the statutory rate will improve investor performance,” said Dubay. “Even if adopted without raising the statutory rate, the revenue cost would be modest.”

Under current law a taxable capital gain occurs whenever stock is sold for a price higher than its original purchase price, and the entire gain is taxable. A capital loss is the reverse. But the tax code doesn’t permit the entire loss to be deducted from other taxable income. Instead only \$3,000 of capital loss can be deducted each year.

“Economists usually define income as ‘anything that increases a person’s ability to consume,’ and capital gains certainly do that,” said Dubay. “But inflationary gains, however, do not.”

It is often argued that indexing capital gains would add significantly more complexity to the already onerous income tax. The study finds this is not the case, as indexing adds no more complexity than an additional tax exemption in the code would. Just as other tax authorities have done, the IRS would simply publish a table of inflation figures.

“The indexation of capital gains for inflation is an issue that’s good economics, and good politics,” said Dubay. “And it may offer a start to bi-partisan tax reform.”

Read the full report, “Issues in the Indexation of Capital Gains” online at www.taxfoundation.org.



Depression-Era Gross Receipts Taxes Making a Comeback?

A specter is haunting state and local business tax climates—the return of Depression-era “gross receipts taxes or ‘turnover taxes’” according to a new study by the Tax Foundation.

“As companies become more flexible and mobile, state corporate income taxes are getting harder to enforce,” said Andrew Chamberlain, an economist at the Tax Foundation and co-author of a new study of gross receipts taxes. “In response, many state lawmakers are unfortunately looking to replace them with crude and inefficient gross-receipts-style tax systems.”



The Tax Foundation study found that gross receipts taxes lead to harmful “tax pyramiding,” encourage companies to consolidate into less efficient firms for tax reasons, and may damage the performance of state and local economies over time.

“Advocates of gross receipts taxes argue they are simple and have low rates,” said Chamberlain. “But these benefits of gross receipts

taxes are illusory. Lawmakers are almost always forced to add complexity to correct for their structural flaws, and some industries end up facing high effective tax burdens despite low statutory rates.”

Gross receipts taxes have a simple structure, taxing all business sales with few or no deductions. Because they tax transactions, they are often compared to retail sales taxes. However, they differ in a critical way.

While well-designed sales taxes apply only to final sales to consumers, gross receipts taxes tax all transactions, including intermediate business-to-business purchases of supplies, raw materials and equipment. As a result, gross receipts taxes create an extra layer of taxation at each stage of production that sales and other taxes do not—something economists call “tax pyramiding.”

“From an economists’ standpoint, there is an inherent flaw in gross receipts taxes,” said Patrick Fleenor, Chief Economist at the Tax Foundation. “Industries that make products that require several business transactions from the time a raw material becomes something sold in a store end up with multiple layers of taxation.”

The study found that European countries experimented with turnover taxes as early as the 14th Century. But gross receipts taxes didn’t become popular in the United States until the onset of the Great Depression in 1929.

“During the Depression, state and local economies sank into deep recession,” said Chamberlain. “Property and income tax collections plummeted sharply, precipitating fiscal crises in many states.”

Frantic for stable sources of tax revenue, lawmakers soon turned to sales and gross receipts taxes as emergency revenue sources.

The study shows that while gross receipts taxes may appear to be a simple alternative to complex corporate income taxes, this simplicity comes at a great cost.

“Gross receipts taxes suffer from severe flaws that are well documented in the economic literature, and rank among the most economically harmful tax structures available to lawmakers,” said Fleenor.

The study shows that the economic problems with gross receipts taxes are not the result of poor design by lawmakers, but are inherent in gross receipts taxes.

“State lawmakers searching for alternatives to complex state corporate income taxes should be wary of gross receipts taxes,” said Chamberlain. “As a tax structure, they are so economically flawed that they should be left in the history books, not in state tax codes.”

Read the full report, “Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes” online at www.taxfoundation.org.

“Gross receipts taxes suffer from severe flaws that are well documented in the economic literature.”

"Property tax collections have grown faster than any other major tax source over the past five years."



"About half of all property taxes go to fund public schools," said Prante. "So that's an important factor influencing property tax burdens."

Tax Politics Are Local

Property taxes are almost entirely the province of local governments, especially school districts.

State-level property taxes exist in 38 states, but those are rarely levied on real property. Rather, they are levied on personal property like cars and boats. Even these taxes are small, providing less than one percent of total state revenue.

Local governments, on the other hand, collect an enormous portion of their tax revenue from property taxes—73 percent in the most recent year.

In recent years, rising property taxes have prompted some lawmakers to introduce legislation that aims to provide property tax relief—including new income taxes, sales taxes, cigarette taxes, slot machines, lotteries, and more.

"It's no surprise that governors routinely campaign on property tax cuts, and that school-board elections are dominated by property tax debates," said Prante.

However, the study also found that the recent decline of the housing market may force local governments to cut spending—or increase property taxes.

Some analysts have predicted that the recent slowing of home prices could continue for some time. If so, there could be important consequences for local governments, especially school districts that rely heavily on property taxes.

"If property values were to continue to fall in some jurisdictions, there would likely be a combination of three policies taken by local school districts," said Prante. "First, they may raise property tax rates to boost revenue; second they may cut spending; and third, they may simply ask for more money from state and federal governments."

Spending Cuts on the Horizon?

The possibility of falling property values in the coming years—and property tax revenues with them—should serve as a warning to local governments that grim budget days may lie ahead.

"Hopefully, local governments have not become overly dependent on property tax revenue that is unlikely to continue increasing at the very high rates of recent years," said Prante. "That is, government planning should try to factor this risk into their plans for future spending."

Between 1982 and 2004, property taxes rose from \$704 per person to \$1,089 per person in the U.S., in 2004 inflation-adjusted dollars. What the future has in store for property taxes will mostly be determined by housing prices. But local governments can stem the rising tax bills in the process by lowering rates, and not simply spending windfall property tax revenue on new and expanded programs.

"The most heated debates in recent years throughout state capitals and local governments have been over rising property tax bills," said Prante. "Although home price increases have slowed recently, taxpayers' distaste for state and local property taxes is likely to continue indefinitely."

Read the full report, "Property Tax Collections Surged with Housing Boom" online at www.taxfoundation.org.

Tax Fact:

Number of Americans who pay zero federal income taxes: 43.4 million.

Making Taxes Simple: Why Cigarette Taxes Cause Crime

Whenever cigarette taxes are increased, advocates of public health celebrate. But there's another group with less admirable motives that often celebrates as well—street gangs that profit from cigarette smuggling.

Simple economics shows the higher the tax rate on cigarettes, the more the market for them resembles that of illegal drugs and alcohol during 1920s Prohibition. As tax rates rise criminals have incentives to acquire cigarettes illegally, often through armed robbery of local merchants. This allows them to re-sell stolen cigarettes on the black market, avoid paying the tax, and pocket a profit that's equal to the per-pack cigarette tax.

With a low tax of 5-cents per pack, there's not much profit in this scheme. But when they rise to today's high levels of more than \$2 per pack, taking the risk of sell-



ing illegally starts looking more attractive to organized crime, as well as neighborhood street gangs.

“Armed robbery, kidnapping, and even murder are committed because of the cigarette smuggling trade,” said Tax Foundation Chief Economist Patrick Fleenor in a recent study, “all because of a hard-to-enforce tax that dangles easy money in front of the criminal element.”

Learn more about the impact of cigarette taxes on crime rates at <http://www.taxfoundation.org/research/topic/103.html>.

Looking Ahead

Alternative Minimum Tax: Congress enacted the AMT in 1969 to make sure that a small number of wealthy individuals paid a minimum amount of taxes, but in 2007, an estimated 23.4 million Americans will be affected by the antiquated tax. Incoming chair of the House Ways and Means Committee, Charles Rangel (D-NY) and incoming Senate Finance Committee chair Max Baucus (D-MT) have said they plan to make reforming the tax a priority. Look for it to be an important issue for the new Congress.

Capital Gains Tax: In the outgoing Congress, Representatives Mike Pence (R-IN) and Eric Cantor (R-VA) co-sponsored H.R. 6057, which proposed indexing capital gains to inflation. Right now, Americans are taxed on gains realized from their investments, but because inflation is not taken into account, the gains are not fairly assessed on the basis of actual purchasing power. Democrats have different views than Republicans on cutting capital gains taxes, but indexing the tax may be one area that the parties can agree on. (For more on inflation indexing and the capital gains tax, see page 4.)

Senate Pay-As-You-Go (PAYGO) Rules: The new Senate may move to restore Pay-As-You-Go-Rules, which attempt to force the chamber to offset or “pay for” increases in entitlement spending or reductions in taxes.

From the Archives: 1962

PLUCKED



Taxes collected (excluding social insurance) by Federal, state and local governments reached an all-time high, \$116 billion in fiscal 1961, or \$650 for every American. The per person size of the tax burden by tax category is shown above; the individual income tax is largest.
(2 column mats available without charge on request)

New Tax Foundation Team Members

Thanks to the generous support of our donors, the Tax Foundation continues to expand its scholarship and outreach. We're pleased to announce three new talented members of our Washington, D.C. staff:

Lisa Hazlett

Lisa Hazlett joins the Tax Foundation as our Director of Development. Previously, Lisa was the Founder & Chairman of the Montana Policy Institute, which she founded at the request of the State Policy Network and the Atlas Economic Foundation. She also served as Director of Foundation Strategy for the Institute for Humane Studies and the Mercatus Center at George Mason University, and Vice President for External Affairs for the Buckeye Institute in Columbus, Ohio. She has extensive experience working with legislators, local public officials, and community leaders on a variety of areas, particularly in the areas of Taxpayer Bill of Rights, education policy, and the needs of the disabled. Ms. Hazlett is a native of Jacksonville, Florida and holds a B.A. from the University of North Florida and an M.B.A. from the Davis School of Business at Jacksonville University.

Megan Carpentier

Megan Carpentier joins the Tax Foundation as our Manager of Government Relations. She brings extensive experience in promoting sound economic and tax policies to Congress and state legislatures through her work for the Association of Equipment Manufacturers and the Automotive Aftermarket Industry Association. Megan graduated *summa cum laude* with Distinction from Boston University with a degree in German Literature and Sociology. She received a Masters of Science in Foreign Service from Georgetown University with a concentration in International Business and Public Policy.

Brian Phillips

Brian Phillips joins the Tax Foundation as our Manager of Media Relations. He works closely with local, national and international broadcast media outlets to ensure sensible, simple, and fair tax policy is represented in public debate. Phillips coordinates outreach to news organizations to promote Tax Foundation products and projects. Before joining the Tax Foundation, Phillips was the Media Services Administrator at the Heritage Foundation. He has given lectures on political communication and hosted a weekly radio program. Phillips holds a B.A. in Government from the University of Texas at Austin.

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- Las Vegas Review-Journal, "Nevada holds fourth in tax climate study"
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