

Tax Watch



Easing the Pain: Where Are America's Lowest Taxes?

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Taxes are a fact of life for all Americans. But thanks to big differences in state and local taxes around the country, some lucky residents bear a much lighter burden than others.

According to a new Tax Foundation study, choosing where to live, work and own property can have a big impact on your annual tax bill. Differences in property, sales and income taxes mean moving from one state to another could shave off—or add—thousands to the taxes you pay.

So where are America's lowest taxes? One answer comes from a comprehensive new Tax Foundation study of America's state and local taxes. The study tallied up every state-local tax paid by Americans in each state, showing which states offer the best overall tax bargain.

America's Tax Havens

According to the study, the rugged northern state of Alaska boasts the nation's lowest state and local tax burdens. Alaskans pay an average of just 6.4 percent of their income to state and local governments each year, far below the national average of 9.7 percent.

"The main factor driving Alaska's low burden is how many taxes are 'exported' onto residents in other states," said Gerald Prante, economist at the Tax Foundation and author of the report.

Alaska relies heavily on oil severance taxes, the burden of which falls mostly on residents of other states who buy gas and heating oil. These exported taxes mean Alaskans pay less at home.

Another factor is Alaska's lack of an income tax. Only seven U.S. states have no income tax—Alaska, Florida, Nevada,

South Dakota, Texas, Washington and Wyoming. But unlike the others Alaska also has no state-level sales tax.

Behind Alaska, the second lowest taxes are enjoyed by residents of Nevada. Taxpayers in the sunny Sagebrush State pay only slightly more than Alaskans at 6.6 percent of income. Like Alaska, Nevada exports many taxes through tourism—mostly on casino and hotel visitors of Las Vegas.

According to the study tax exporting isn't limited to oil- and tourism-rich states. The





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Message from the President: Will the Last Taxpayer Standing Please Turn Out the Light?



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, 45.6 million tax filers—one-third of all filers—have no income tax liability after taking their credits and deductions. For good or ill, this is a dramatic 57 percent increase in the number of “non-paying” Americans since 2000.

Both the McCain and Obama plans would increase the number of tax filers with zero liability (or less) by expanding existing tax provisions or creating new ones. If all the Obama tax provisions were enacted in 2009, the number of non-payers would rise by about 15 million, to 62 million overall. If all the McCain tax proposals were enacted, the number of non-payers would rise by about 13 million, to a total of 60 million overall.

The tax code has always contained measures that minimize the income tax burden for low-income workers. Between 1950 and 1990, the percentage of tax filers who owed no tax averaged 21 percent. However, since the early 1990s lawmakers have increasingly turned to using targeted tax credits to achieve specific social policies such as helping families with children, helping students with college tuition, or helping consumers buy hybrid cars.

Most credits can only reduce a taxpayer’s amount due to zero, but the EITC and the Child Credit were also made refundable, meaning taxpayers are eligible to get money back even if they have no income tax liability. Those tax returns have become, in effect, a claim form for a government subsidy delivered through the tax system rather than traditional government programs like welfare or farm subsidies.

Aside from shrinking the tax rolls and forcing up tax rates, there are many other undesirable effects of these credits:

More Complexity: The explosion of tax credits has added a tremendous amount of complexity to the tax code. The EITC, for example, is so complicated that more than three-quarters of those claiming it pay a tax preparer to complete their forms.

Punitive Marginal Tax Rates: Because these credits phase out as people’s incomes rise, some low-income Americans can face a higher effective marginal tax rate than the most affluent taxpayers.

Narrowing the Tax Base: Increasing the number of non-payers dramatically shrinks the tax base and puts greater stress on the remaining taxpayers who must shoulder the nation’s tax burden. The top 20 percent of taxpayers now pay more than 85 percent of all income taxes.

By forcing the IRS to administer a vast array of tax credits and deductions, Congress risks transforming the agency into an extension of the welfare system. It’s time for a serious public discussion of whether it’s desirable for so many Americans to be disconnected from the cost of government and of the negative consequences of using the tax code as a tool for social policy.

Sincerely,



Scott A. Hodge

Study: Lower Tax Rates Spur Income Growth

Most tax cuts aim to cut government revenue. But according to a new Tax Foundation study some tax cuts boost the economy enough to shrink their budget cost by up to 40 percent.

The new study from Tax Foundation Vice President for Economic Policy Robert Carroll examined the recent 2001 and 2003 Bush tax cuts. The centerpiece of the cuts was lower income tax rates—the 15 percent rate was cut to 10 percent and the top rate was lowered from 39.6 percent to 35 percent.

After tax rates were cut, the study found taxable income grew sharply as Americans reported extra income. This income boost offset between 25 and 40 percent of the revenue loss to the U.S. Treasury.

“This research shows that while lower tax rates have not paid for themselves,

they do provide important economic benefits,” said Carroll. “Lower rates can expand the tax base to such an extent that they cost the federal government substantially less revenue than the casual observer might think.”

According to the study, if taxpayers hadn’t responded at all to lower tax rates their tax cut would have been about \$29.7 billion. But since the lower tax rates induced workers and investors to increase their taxable incomes by about 3 percent the tax cuts only cost the Treasury \$18.5 billion.

“That means an estimated 25 percent to 40 percent of the static revenue loss was offset by the tax-induced increase in the tax base,” said Carroll.

The study notes several ways tax cuts can boost income. Some taxpayers work harder and for longer hours; take riskier and higher-paying jobs; choose entrepreneurship over wage earning; shift earnings from nontaxable fringe benefits to taxable wages; or rely less on tax-favored consumption like debt-financed home ownership.

Expiring Tax Cuts May Hurt Economy

The study comes at a time when the impact of tax changes is especially important. The 2001 and 2003 tax cuts are scheduled to expire at the end of 2010. If they do the top tax rate will rise to 39.6 percent—potentially shrinking the nation’s taxable income.

“Letting the 2001 and 2003 tax cuts expire would end an eight-year rate reduction that helped spur the economy in the long-term by improving the incentives to work, produce and save,” said Carroll.

During the Reagan years the top income tax rate was cut from 50 percent to 28 percent in 1986. Tax increases followed during the Clinton years, as the top rate was raised to 31 percent in 1991 and again to 39.6 percent in 1993. These tax increases undid roughly half the Reagan rate cuts from the 1980s. By comparison, the 2001 and 2003 Bush tax cuts were relatively modest as they reversed only half the 1990s tax hikes and left the top rate well above the 28 percent rate from the 1980s.

“Recent tax cuts have had important behavioral responses throughout the economy,” said Carroll. “There may be important adverse economic consequences if the 2001 and 2003 tax cuts are allowed to expire.”

Read the full study, “*The 2001 and 2003 Tax Relief: The Benefit of Lower Tax Rates*,” at www.taxfoundation.org/publications/show/23534.html.



“There may be important adverse economic consequences if the 2001 and 2003 tax cuts are allowed to expire.”

Tax Fact:

Highest property taxes per household in 2006: New Jersey, \$6,581.
Lowest: Arkansas, \$682.

New Legal Briefs Defend Taxpayers in the Courts



"Taxpayers are not well served by judicial mandates for higher taxes."

The Tax Foundation continued fighting for taxpayer rights in the courts this summer, filing two new legal briefs in Texas and Indiana.

In a friend-of-the-court brief filed with the Texas Supreme Court, the Tax Foundation urged the reversal of a comptroller's ruling imposing higher taxes on insurance companies from other U.S. states.

In the brief, Tax Foundation Tax Counsel Joseph Henchman argues that the comptroller's ruling for higher taxes would force other states to raise their tax rates on Texas insurance companies, setting off a tit-for-tat interstate tax war that ultimately hurts American consumers.

"Failing to overturn the comptroller's ruling will set off a chain reaction

of tax increases on out-of-state insurance companies until no companies do interstate business at all," said Henchman. "These tax increases would ultimately fall on the American public in the form of higher prices for consumers, lower stock returns for investors, and lower wages for workers."

In the Texas case—*First American Title Insurance Company v. Combs*—the Court was asked to reverse a comptroller's decision allowing Texas to impose huge retaliatory taxes on out-of-state companies whenever Texas companies are taxed by other states. For example, if another state imposed a 2 percent tax on Texas insurers, Texas would retaliate with a 3.1 percent tax on that state's insurers.

"Reversing this decision will help avoid an interstate tax war and a 'race to the top' in state taxation of insurance companies," said Henchman.

Fighting Court Mandated Tax Hikes

In a second brief filed with the Indiana Supreme Court the Tax Foundation argued for the reversal of a Court of Appeals decision creating a judicially enforceable right to a "quality" education at taxpayer expense.

In the brief, Tax Counsel Joseph Henchman argues that the Court's reasoning goes beyond the meaning of the "education clause" of the Indiana Constitution, and that they ignore problems other states have had with judicial school-funding mandates.

"Nothing in the education clause establishes a specific, defined level of education that must be attained as long as the state maintains a generally supportive stance towards knowledge and learning," said Henchman. "The Education Clause guarantees a free public education, not the right to a 'quality' education at taxpayer expense."

The suit—*Bonner v. Daniels*—seeks a judicial order to boost public school funding, an area normally left to lawmakers. The Tax Foundation brief noted that Indiana's lower court focused improperly on higher taxes as the only way to improve public education.

"It's problematic to say that more taxpayer money always means better performance in public schools," said Henchman. "A focus on dollar amounts ignores potential efficiency increases, the diminishing returns of added spending, and alternative uses for each dollar."

Previous Tax Foundation studies show that judicial mandates for higher taxes for public schools typically boost spending only temporarily while increasing taxes permanently. A 2007 study, "Appropriation by Litigation: Estimating the Cost of Judicial Mandates," catalogs the problems caused by judge-mandated tax hikes.

"Courts are not prepared to weigh these policy issues," said Henchman. "And taxpayers are not well served by court mandates for increased taxes."

Read the full briefs online at www.taxfoundation.org/publications/showtype/34.html.

Tax Fact:

Average per-household burden of U.S. corporate taxes in 2007: \$3,190.

CompeteUSA Campaign Highlights Cost of Corporate Taxes



"Wages and living standards are threatened as long as business taxes remain above the world average."

The Tax Foundation launched an educational campaign this fall aimed at exposing the "real wallet" impact of America's high corporate tax rates on American workers, consumers and business owners.

"The goal of *CompeteUSA* is to raise public awareness of America's high business tax rates and how those taxes are affecting our competitiveness, wages and living standards," said Scott A. Hodge, President of the Tax Foundation.

According to the campaign, just 20 years ago the U.S. led the world in cutting business taxes to make our economy more conducive to job creation.

Since then, every other industrialized country in the OECD has cut its business taxes while U.S. corporate taxes have remained unchanged.

"Today, only Japan has a higher business tax rate than the U.S.," said Hodge. Last year, 27 countries cut their business taxes to make their economies more competitive and attractive to investment. This

year, more countries—including Korea, Taiwan, Hong Kong, and South Africa—have announced cuts in their corporate tax rates. Even the Japanese government has begun studying the idea.

Educating Americans on Business Taxes

CompeteUSA's first project is a new website at www.taxfoundation.org/competeusa/. The campaign also includes national television ads, internet advertising, new studies on economic competitiveness, op-eds from national economic leaders, and a \$5,000 contest for the best internet video illustrating the impact of business taxes on jobs, wages and the economy.

The *CompeteUSA* campaign comes on the heels of new data released by the OECD showing the United States has

the second-highest corporate tax rate in the world. Another new OECD study found corporate taxes are the single most harmful tax to GDP growth—even more harmful than individual income taxes or consumption taxes.

"Tax Foundation studies have found the poorest 20 percent of households pay more in corporate income taxes each year than they pay in individual income taxes," said Hodge. "American workers have a lot to gain from corporate tax reform."

Previous Tax Foundation studies have shown corporate income taxes make up roughly 6.3 percent of low-income households' tax bills, while personal income taxes make up just 4 percent.

"Wages and living standards of American workers are threatened as long as our business tax system remains out of line with the rest of the world," said Hodge.

"The goal of this campaign is to lay the groundwork for reform by raising America's I.Q. on business taxes."

The campaign cites many surprising statistics about corporate taxes:

- The combined corporate tax rate in the U.S. stands at 39.3 percent. The OECD average rate is just 26.6 percent.
- Federal corporate income taxes collected \$370 billion in 2007. That's an average household burden of \$3,190 per year—more than the average household spends on restaurant food, gasoline or home electricity in a year.
- A 2006 working paper from the Congressional Budget Office found that 70 percent of corporate tax burdens fall on domestic workers through lower wages, while 30 percent fall on company shareholders.

"When it comes to pro-growth business taxes, it's time for America to be a world leader again," said Hodge.

Visit the *CompeteUSA* campaign website at www.taxfoundation.org/competeusa/.

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"Some lucky residents bear much lighter state and local tax burdens than others."

sheer volume of travel and trade between states means every state ends up exporting and importing some taxes.

"Of the average state-local tax burden of \$4,283 per person, \$1,358 or 32 percent is paid to governments in other states," said Prante. Much of this occurs through cross-border sales, hotel, restaurant and rental car taxes.

Behind Alaska and Nevada the next lowest taxes are found in Wyoming (7 percent of income), Florida (7.4 percent), and New Hampshire (7.6 percent).

America's High-Tax States

Just as some states offer tax bargains, others tax far above the national average. The study found America's highest taxes in New Jersey. Residents of the north-eastern Garden State pay a whopping

11.8 percent of their income to state and local governments—nearly 85 percent higher than Alaska.

"New Jersey's taxes top the list for two reasons," said Prante. "High government spending that requires high taxes, and high tax payments to out-of-state governments." For example, New Jersey residents own more shares of stock than most. When other states raise corporate taxes these burdens are disproportionately borne by New Jersey residents.

The second-highest taxes are paid by New Yorkers at 11.7 percent of income. Connecticut is third at 11.1 percent, followed by Maryland (10.8 percent), Hawaii (10.6 percent), California (10.5 percent) and Ohio (10.4 percent).

The latest study marks the 18th consecutive year the Tax Foundation has published state-local tax burden estimates. According to Prante, what sets the study apart is the focus on taxpayers rather than tax collectors.

"Most other reports focus on how much governments in each state collect," said Prante. "Our study takes a different approach that focuses on taxpayers. We count taxes regardless of the location of the government that profited from it."

For example, many Connecticut residents work in New York City and pay income tax there, but the Census Bureau counts those as part of New York's taxes. In contrast, the Tax Foundation counts them as part of Connecticut's tax burden since that's where the taxpayers live.

Similarly, when vacationers visit Las Vegas casinos the Census Bureau counts the hotel, rental car and restaurant taxes they pay as part of Nevada's tax burden. The Tax Foundation instead uses economic tools to push those taxes back to states where vacationers actually live.

"Our study lets policymakers go beyond a tally of collections to the deeper question: Which state's residents bear the heaviest burden from taxes?" said Prante.

Read the full study, "State-Local Tax Burdens Dip As Income Growth Outpaces Tax Growth," at www.taxfoundation.org/publications/show/22320.html.

Obama Plan May Redistribute Billions through Tax Code

If Sen. Barack Obama wins the White House this fall there may be big changes in how the nation's taxes are distributed. That's the finding of a new Tax Foundation analysis by Scott A. Hodge.

Using estimates from the left-leaning Tax Policy Center, Hodge shows Obama's plan would greatly accelerate the decades-long trend toward an income tax that raises nearly all revenue from a few high-income Americans.

"Under the Obama plan more than \$131 billion would be redistributed from the top 1 percent of taxpayers to all other taxpayers," said Hodge.

As a result, the top 1 percent of households would pay more federal taxes than the bottom 80 percent under the Obama plan.

This contrasts starkly with the McCain plan, which Hodge found would give every taxpayer a cut and leave the current tax distribution approximately the same.

"Under Obama's plan 1.1 million Americans would pay more in federal taxes than 128 million of their fellow citizens combined," said Hodge. "Can a tax system so focused on redistribution really be compatible with economic growth?"

Read the full study, "Hard Numbers on Obama's Redistribution Plan," at www.taxfoundation.org/publications/show/23319.html.

Media Impact Report

With the presidential campaigns in full swing, Tax Foundation experts were cited throughout the popular media this summer:

Television

Tax Foundation President Scott Hodge appeared on CNBC to discuss America's high corporate tax rates. Hodge cited an OECD report showing that America has the second highest corporate tax rate among industrialized countries. Also, Tax Counsel Joseph Henchman appeared on Fox Business News to argue for broad-based tax cuts rather than political gimmicks like sales tax holidays.

Newspapers

The Wall Street Journal, New York Times, and the New York Sun all published articles citing Tax Foundation research on the

harmful effects of heavy corporate tax burdens. *The Atlanta Journal-Constitution* and the *Rocky Mountain News* cited Tax Foundation research comparing the presidential candidates' tax plans. Dozens of local papers printed stories on the Tax Foundation's new estimates of state and local tax burdens around the country.

Website

This summer the Tax Foundation launched its *CompeteUSA* campaign, including a new website section, television ads and an online video contest (see page 5 for more on *CompeteUSA*). In the first half of 2008 the Tax Foundation website had 2.3 million visitors—a 33 percent increase over 2007. The number of visitors to the Tax Foundation's free online publications library increased by 77 percent compared to last year.

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

Bringing Sound Tax Policy to the States

The Tax Foundation's state policy team has been busy working at the ground level in Mississippi, Texas, Illinois, Nevada, Louisiana and North Carolina, impacting tax policy at the state level. Here's a brief summary:

Mississippi: Following up on his testimony this spring, Tax Counsel Joseph Henchman submitted additional studies and reports to the forty-member Mississippi Tax Study Commission as it prepared to make final tax reform recommendations to the legislature.

Texas: Tax Foundation President Scott Hodge addressed activists at the Americans for Prosperity annual conference in Austin in June.

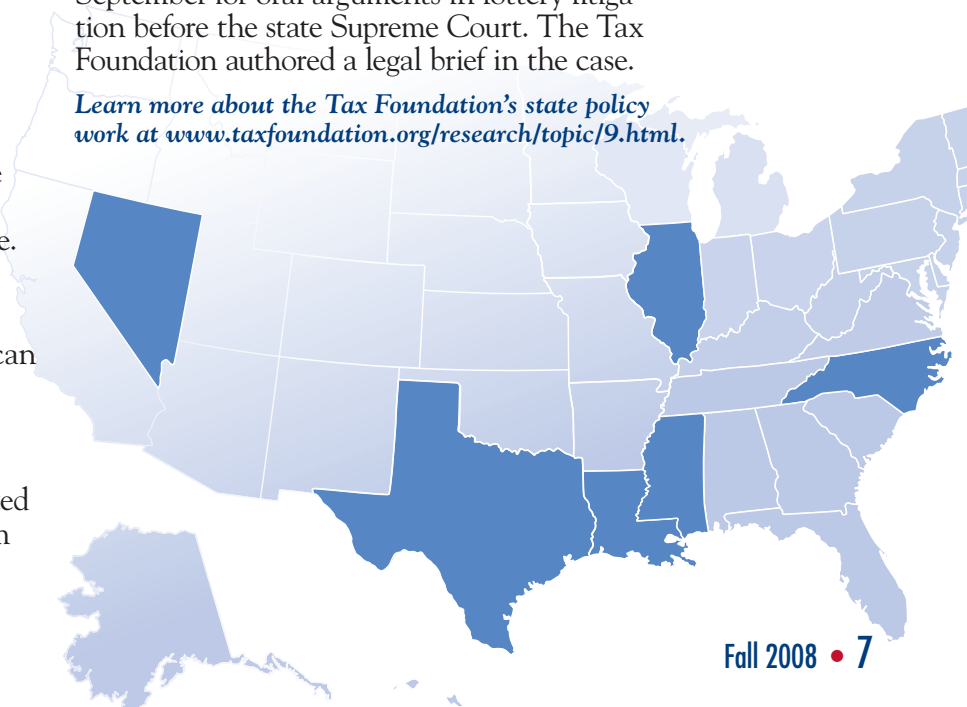
Illinois: In July, the Tax Foundation hosted a reception in Chicago for state legislators in town for the annual conference of the American Legislative Exchange Council. A packed room heard remarks from Scott Hodge and Dr. Richard Vedder of Ohio University.

Nevada: Tax Foundation researchers distributed studies and answered questions at the Freedom Fest annual event in Las Vegas in July.

Louisiana: In July, Tax Foundation economist Josh Barro hosted a panel on Louisiana's tax and spending policies during the annual meeting of the National Conference of State Legislators.

North Carolina: Tax Foundation Tax Counsel Joseph Henchman traveled to Raleigh in September for oral arguments in lottery litigation before the state Supreme Court. The Tax Foundation authored a legal brief in the case.

Learn more about the Tax Foundation's state policy work at www.taxfoundation.org/research/topic/9.html.



Meet the Future of Sound Tax Policy

Each summer the Tax Foundation welcomes interns from across the country to our Washington, D.C. office. Working directly with our economists, interns learn valuable lessons that prepare them for a lifetime of promoting sound tax policy. Here's an introduction to our 2008 interns:

Sarah E. Larson is pursuing an MPA at Indiana University. In the fall Sarah will begin doctoral studies with a focus on public policy, Congressional systems, and theory and methods for quantitative research. Sarah graduated from Miami University (Ohio) in the spring of 2007 with honors in political science.

William J. Luther recently completed an Economics degree with honors at Capital University. In the fall he will be attending George Mason University to pursue a Ph.D. in Economics. He is interested in development economics and spent several months

studying at the University of Cape Town, South Africa in 2007. William's internship was supported by the Charles G. Koch Summer Fellowship Program.

Robert K. Schmidt is a graduate student at Indiana University where he is working on his master's degree in Public Affairs. For the past two summers, he has worked as a lecturer at Valparaiso University, teaching undergraduate economics. After graduation, Bob hopes to continue teaching economics on a part-time basis while working in federal or state government finance.

Keren (Kevin) Zhou is a senior at the University of California, Berkeley, pursuing his bachelor's degree in Mathematics and Economics. Upon graduation, Kevin plans to work in the private sector before pursuing his MBA, and he eventually hopes to work on Wall Street. Kevin's internship was supported by the Foundation for Teaching Economics.

Learn how to sponsor a Tax Foundation internship today by calling (202) 464-6200.



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