Tax Watch

Summer 2008

TAX FOUNDATION
Since 1937

Slowing the Beast: America's Tax Burden Falls in 2008

American taxpayers got a welcome dose of good news this year. Thanks in part to millions of tax stimulus checks mailed by the IRS, the nation's tax burden fell for the first time in five years.

According to the Tax Foundation, Tax Freedom Day—the day each year when America has earned enough to pay for government and starts working for itself—arrived April 23rd this year. That's three days earlier than last year, and more than a week earlier than the all-time high of May 3rd in 2000.

But don't celebrate yet. Taxes still consume nearly one-third of America's income—more than any other expense in the average family budget.

Taxes Down But Still Heavy

"The President's tax stimulus plan and projections of slower economic growth in 2008 are the main reasons for the earlier Tax Freedom Day this year," said Scott A. Hodge, President of the Tax Foundation. "But despite the small drop in taxes, America still works almost four months to pay our federal, state and local tax bills."

Each year, the Tax Foundation releases a detailed study of the nation's total tax burden. The study includes every tax in America—federal, state and local. In addition to announcing Tax Freedom Day, the study compares taxes to the cost of other household expenses.

"The cost of government continues to dominate the American taxpayer's budget," said Hodge. "Americans will spend more on taxes in 2008 than they'll spend on food, clothing and housing costs combined."

In 2008, Americans will work 74 days to earn enough for federal taxes and 39 more days for state and local taxes. Meanwhile, buying food requires just 35 days of work, clothing 13 days, and housing 60 days. Other major expenses are health and medical care (50 days), transportation (29 days), and recreation (21 days).

"During the eight years of the Bush administration, the nation's tax bill has been a see-saw affair," said Tax Foundation Senior Economist Gerald Prante, co-author of the new report.

In 2000, Tax Freedom Day was celebrated May 3rd, the latest date ever. Then a string of tax cuts between 2001 and 2003 pushed Tax Freedom Day

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TaxWatch

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TAX FOUNDATION Since 1937

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Message from the President:

Corporate Tax Reform Needs "Sputnik Moment"

One of the defining moments of the post-World War II era was October 4th, 1957. No, that's not the day I was born (that blessed event would come 15 months later). It's the day the Soviet Union launched Sputnik I, which rocked Americans' sense of technological superiority and ignited the "space race."

After three years of failed attempts to catch up to the Soviet program, President John F. Kennedy boldly announced to Congress in 1961 that "…I believe that this nation should commit itself to achieving the goal, before this decade is out, of landing a man on the Moon and returning him back safely to the earth." Eight years later, Neil Armstrong walked on the moon.

Throughout our history, Americans have always risen to the challenges presented by advancements in other nations, whether in technology, sports or business. However, when it comes to taxation America has fallen behind virtually every other country on earth. Not only are we doing nothing to fight back, but most Americans—and their lawmakers—are unaware of the problem.

As I've written here before, among industrialized countries only Japan has a higher corporate tax rate than the U.S. Last year alone, 27 nations cut their corporate taxes. Others—including Canada, Hong Kong, Korea, South Africa and Taiwan—have announced further cuts this year.

What kind of Sputnik-like event will awaken Americans to this problem and force Washington to regain our competitive edge in the global tax competition?

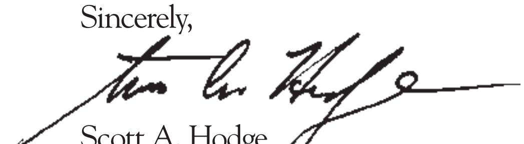
Perhaps we'll face a crisis similar to what British Prime Minister Gordon Brown's administration is currently experiencing. In recent months, two large British firms—Shire Pharmaceuticals and United Business Media—announced they will be reincorporating in Ireland to take advantage of that country's 12.5 percent corporate tax rate.

Will our Sputnik moment arrive when a major U.S. company finally announces it is moving to Ireland or another low-tax country? After all, the U.S. corporate tax rate is 11 percentage points higher than Britain's.

The only thing preventing such moves are various tax penalties and the stigma of being branded as a "Benedict Arnold" company by Washington politicians. Of course, if the act of moving from a high-tax place to a low-tax place was so treasonous, millions of Floridians—including my father, Tiger Woods, and George Steinbrenner—must be less patriotic than New Yorkers who bravely endure the highest taxes in the nation.

But another way a U.S. firm can change its country of incorporation is to be purchased by a foreign-owned firm. It will be interesting to see how the presidential candidates react if InBev, a jointly held Belgian and Brazilian beverage company, is successful in its hostile takeover attempt of Anheuser-Busch—the quintessential American brand. In the end, it could be a good deal for Anheuser-Busch shareholders, but bad for the U.S. Treasury. Come to think of it, I'll drink a toast to that.

Sincerely,



Scott A. Hodge

Sizing Up Obama's Social Security Tax Plan

For most Americans, payroll taxes are already a heavy burden. But if a proposal from Sen. Barack Obama becomes law, Social Security taxes will be on the rise for over 10 million American workers.

Under the Obama plan the wage cap on payroll taxes would be abolished. Today the tax only applies to the first $102,000 in earnings. Lifting the cap would dramatically raise taxes on workers earning wages above that level.

"If the Social Security wage cap is abolished, upper-income states like California, New York, New Jersey, Maryland and Connecticut will bear the brunt of the tax increase," said Gerald Prante, Senior Economist at the Tax Foundation and author of the new study.

Under the plan, a staggering 1.67 million workers in California alone would pay higher payroll taxes. In New York, 821,000 workers would face a tax increase on their earnings. And in New Jersey, roughly one out of every ten workers would face lower take-home pay—514,000 workers in total.

"Under the Obama plan, payroll taxes would increase for 10 million American workers."

"Overall the Obama plan would raise payroll taxes on approximately 10.1 million workers, or roughly 6.25 percent of the U.S. workforce," said Prante.

The least-affected states would be those with the most low-income workers who already earn less than the wage cap. For example, in Montana, North Dakota and South Dakota fewer than 3 percent of workers earn above the current wage ceiling of $102,000.

Millions Would Pay More

Obama first suggested lifting the wage cap in an editorial in the *Quad City Times* in September 2007. Critics pointed out that the plan would violate his promise not to raise taxes on anyone earning under $250,000. Obama replied by saying, "We may want to include a 'donut hole' to ensure that lifting the payroll tax cap does not ensnare any middle class Americans."

If the proposal becomes law, the study notes that marginal tax rates on many Americans will skyrocket—reaching well above 50 percent of income for some.

"Obama has called for the top federal income tax rate to revert from 35 percent to 39.6 percent," said Prante. "Add to that an uncapped payroll tax rate of 12.4 percent and the typical state's top income tax rate, and the result is a top marginal tax rate of between 55 and 61 percent."

The original Social Security tax was enacted in 1937—the same year the Tax Foundation was founded. Over the years, dozens of Tax Foundation studies have examined its impact on the economy.

A 1966 Tax Foundation study warned that "when a tax has grown to be the largest source of federal receipts after the income tax, the time has come to consider what differences this tax might make to individuals, to business and the economy."

The newest study points to another side effect of Obama's plan for a higher payroll tax: more tax planning.

"The plan could tax away 60 cents of a high-income person's next dollar of wage income," said Prante. "That hurts incentives to work, and rewards those who game the system with complex tax planning."

Read the complete study, "Obama's Plan to Abolish the Social Security Wage Ceiling," online at www.taxfoundation.org/publications/show/23243.html.

Tax Fact:

Highest state-local gas tax per gallon: California, 45.5¢

Lowest: Alaska, 8¢

Senate Testimony: Time to Clean Up the Tax Code

"Innovation is the key to economic growth, and it tends to take place wherever business climates are best."

Fundamental tax reform has dipped below Congress' radar screen lately. But according to Tax Foundation testimony before the U.S. Senate Finance Committee in April, now's the time to tackle our complex and burdensome tax code.

Robert J. Carroll, Vice President for Economic Policy at the Tax Foundation, told congressional tax-writers that fundamental tax reform can cut the nation's compliance burdens, improve America's competitiveness for jobs and investment, and help boost economic growth over the long run.

"The economic sluggishness we read about every day has prompted many suggestions of short-term economic fixes," said Carroll. "But federal tax reform remains one of the most important long-term economic challenges facing the nation."

Carroll testified that the U.S. tax system today is a complicated web of tax rules that impose substantial compliance and economic costs on the economy. These rules may have been well intentioned, but today are a costly drag on the economy by raising compliance burdens and forcing up tax rates.

Corporate Tax Reform Urgent

Among the many flaws in the tax code, Carroll highlighted the urgent need to reform the corporate income tax. Previous Tax Foundation studies show that as America's trading partners have cut corporate tax rates to attract jobs in recent years, the U.S. is being left behind.

"In a world of greater economic integration and increased trade and capital flows, a firm's decision about where to locate and expand its operations will be increasingly influenced by factors such as a country's statutory corporate tax rate and overall investment climate," said Carroll.

By standing still, Carroll warned that the United States should expect to see reduced inflows of foreign capital in the future. In the near-term, this translates into slower economic growth, a slower advance in labor productivity, and less employment.

Carroll also warned about the effect America's high corporate tax rates may have on innovation and entrepreneurship in the U.S.

"Innovation is a key determinant of economic growth, and it tends to take place wherever the investment climate is best," said Carroll. "Higher investment spurs innovation by raising the demand for new technologies. This interplay between innovation and capital accumulation makes failure to reform the U.S. business tax system more damaging to the economy."

Carroll also highlighted the choice between income-based and consumption-based taxes. Consumption taxes tend to reduce taxes on saving and investment compared to our current income tax. He explained how this would help boost economic performance and living standards in a way that retains the current progressivity of the tax system.

"While there are many consumption tax plans—such as the Bradford 'X-Tax' or the retail sales 'Fair Tax'—all would reduce taxes on the return to saving and investment," said Carroll. According to some estimates, replacing our progressive income tax with a flat-rate consumption tax could increase the overall size of the economy by up to 9 percent in the long run.

"Reforming the U.S. tax system poses significant political challenges," said Carroll. "But it also offers the opportunity to rationalize many of the worst aspects of the tax system."

Read the complete testimony, "Tax Fundamentals in Advance of Reform," online at www.taxfoundation.org/publications/show/23123.html.

U.S. States Lead World in High Corporate Taxes

Corporate taxes are falling around the world, but a new study from the Tax Foundation shows many U.S. states now tax job providers at higher rates than France, Germany and Sweden.

"Tax competition for jobs and investment is fierce, and the U.S. continues to fall further and further behind," said Tax Foundation President Scott A. Hodge, author of the study. "U.S. states should be the world's leaders in many things, but high taxation should not be one of them."

According to the study, America's high corporate tax rates are hurting the ability of U.S. states to compete for jobs and investment with foreign countries. That means fewer U.S. jobs and slower economic growth.

Counting the federal rate alone, the U.S. has the world's highest corporate tax rate. But including average sub-national rates—federal plus state tax rates in the U.S.—Japan narrowly edges out the U.S. for the world's highest-tax location for business.

"Twenty-four U.S. states have higher business taxes than any other country in the world."

The new study details corporate taxes by state, adding each state's tax rate to the federal rate. The results show that 24 states impose higher business tax rates than in any other nation in the world. Thirty-two states have a higher corporate tax rate than Germany. All 50 states tax companies more heavily than notoriously high-tax France.

State-Level Relief Needed

"If federal lawmakers are serious about making the U.S. corporate tax system more competitive, they'll need to partner with state lawmakers to lower the nation's overall corporate tax burden," said Hodge. Today, 44 states impose a traditional corporate income tax, with rates ranging from 4.63 percent in Colorado to 12 percent in Iowa. Three states—Michigan, Texas, and Washington—impose gross receipts taxes on businesses. Ohio is currently transitioning from a traditional corporate income tax to a gross receipts-style tax. Only three states—Nevada, South Dakota and Wyoming—do not have a state-level corporate tax.

Assuming that no state cuts its business taxes in 2008, the U.S. federal rate would have to be cut to 20 percent in order to bring the combined federal-state rate down to the middle of the OECD pack.

This year alone, six countries announced plans to cut corporate tax rates: Canada, Hong Kong, Korea, South Africa, Spain and Taiwan. In an interview in the *Korea Times*, a senior government official there said, "The corporate income tax reduction is not a matter of choice, but a matter of life and death for Korea in an increasingly globalized business environment."

A growing body of academic research shows foreign investment is very sensitive to corporate tax rates. A recent study by Georgetown University economist Claudio Agostini found that every 1 percent increase in a state's corporate tax rate is expected to reduce foreign direct investment by roughly 1 percent.

"The key to improving America's business competitiveness is a partnership between federal and state lawmakers," said Hodge. "We need to work toward a common goal of lowering the business tax burden in the U.S. Otherwise, we will continue to fall behind the rest of the world."

Read the full study, "U.S. States Lead the World in High Corporate Taxes," online at www.taxfoundation.org/publications/show/22917.html.

Tax Fact:

U.S. oil industry profits since 1981: $1.12 trillion

Taxes on U.S. oil industry since 1981: $1.65 trillion

(continued from page 1)

> "If the Bush tax cuts expire in 2011, America's tax burden will soon be at record levels."

up by more than two weeks. By 2003, Tax Freedom day shrank to April 16th—the lowest tax burden since 1971.

However, the booming economy in 2005, 2006 and 2007 pushed up incomes and tax collections, pushing Tax Freedom Day back to April 26th. This year, tax stimulus checks and a projected slowing of the economy cut Tax Freedom Day back to April 23.

"The back-and-forth of taxes during the Bush years contrasts sharply with the Clinton years," said Hodge. "During the Clinton administration Tax Freedom Day steadily marched upward each year, from April 20th in 1992 to May 3rd in 2000."

Americans face hundreds of taxes in their daily lives, making it hard to understand the total tax bill. The usefulness of the annual Tax Freedom Day study is that it includes them all—every tax at the federal, state and local levels.

"Five major taxes dominate the tax burden: income, payroll, sales, corporate income and property taxes." said Prante. Of the 113 days it took to pay taxes in 2008, income taxes took 42 days of work. Payroll taxes took another 28 days. Sales and excise taxes—mostly state and local—took 16 days to pay off. Corporate income taxes took 13 days, and property taxes took 12.

Where Are Taxes Lowest?

According to the study, tax burdens vary widely by state. Partly this is due to differences in state and local taxes, and partly because federal taxes fall more heavily on some states than others.

The lowest tax burden in 2008 was in Alaska. Alaskans celebrated Tax Freedom Day on March 29th—more than a week before any other state. Mississippi had the second lowest burden, followed by Montana, West Virginia and Alabama.

"In general, Tax Freedom Day is early in low-income states because the federal income tax hits most of their income at the lowest rates of 10 percent and 15 percent," said Prante. "Alaska stands out as the exception. Income and federal tax payments are above average there, but very low state and local taxes push them to the bottom of the list."

Not surprisingly, the nation's heaviest tax burdens fall on America's high-income states. Taxpayers in Connecticut, New Jersey, New York, California and Washington work the longest to pay their tax bills.

"Taxes may be down this year, but hold onto your wallets," said Hodge. "If Congress lets the Bush tax cuts expire in 2011, America's tax burden will soon be back at record levels."

Read the complete report, "America Celebrates Tax Freedom Day," online at www.taxfoundation.org/taxfreedomday/.

High Gas Prices Fuel Tax Debates

Gas prices may be at record levels, but the presidential candidates' gas tax proposals are mostly hot air according to the Tax Foundation.

The Tax Foundation released a number of analyses this summer to clarify the gas tax debate. In May, President Scott Hodge debunked the myth that U.S. oil companies make large profits without paying taxes on the Tax Policy Blog.

"Between 1981 and 2006, governments collected $1.65 trillion in taxes from domestic oil companies," said Hodge. "That's 65 percent more than the combined profits of those companies during the same period."

In a 2007 study, "Paying at the Pump: Gasoline Taxes in America," the Tax Foundation provided an in-depth history and analysis of gas taxes.

"The original gas tax was designed as a user fee for the nation's roads," said Hodge. "But like most taxes, it has outgrown its original purpose and is often used for wasteful spending."

Windfall profits taxes were also addressed in a recent analysis. Simple economics shows that companies won't end up paying the tax. The study showed how taxpayers across the income spectrum would bear the burden.

"With gas prices on the rise, it's no surprise lawmakers are looking for scapegoats," said Hodge. "Our goal is to discourage bad gas tax policy before it becomes law."

To read more about Tax Foundation research on gas taxes, visit www.taxfoundation.org/research/topic/102.html.

Media Impact Report

So far this year, Tax Foundation experts reached a staggering 63 million Americans through print media alone.

The Tax Foundation has been cited 188 times by publications with more than 100,000 readers, 24 times in publications with over 500,000 readers, and 6 times in publications with more than 1 million readers. These include the *New York Times*, the *Los Angeles Times*, *USA Today*, *Money* magazine and *Time* magazine.

The Wall Street Journal alone has cited Tax Foundation research six times this year—once referring to how many tax filers pay no income tax; twice referring to the *State Business Tax Climate Index*; and three times citing Tax Foundation estimates of combined state and local tax burdens.

On May 7th, Tax Foundation Chief Economist Patrick Fleenor published an op-ed in the *Wall Street Journal* titled, "Cigarette Taxes Are Fueling Organized Crime." Senior Economist Gerald Prante also published an article titled, "The Property Tax Rebellion" in the April 1st edition of *The American Legion*.

Overall, Tax Foundation research has been cited 255 times by the news media in 2008—a pace of nearly two media mentions per day across the country.

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

Bringing Sound Tax Policy to the States

Tax Foundation economists have been busy promoting sound tax policy at the state level this year. Here's a summary of our recent work:

Pennsylvania: The Pennsylvania Republican Study Committee invited Tax Foundation Tax Counsel Joe Henchman to provide testimony in February on state debt and taxation. Tax Foundation President Scott A. Hodge also spoke during a legislative luncheon hosted by the Commonwealth Foundation.

Kentucky: Tax Foundation staff met with Kentucky State Treasurer Todd Hollenbach and his staff in March to discuss ways the public can be educated on sound tax policy. Similar invitations to other state treasurers will be extended this year.

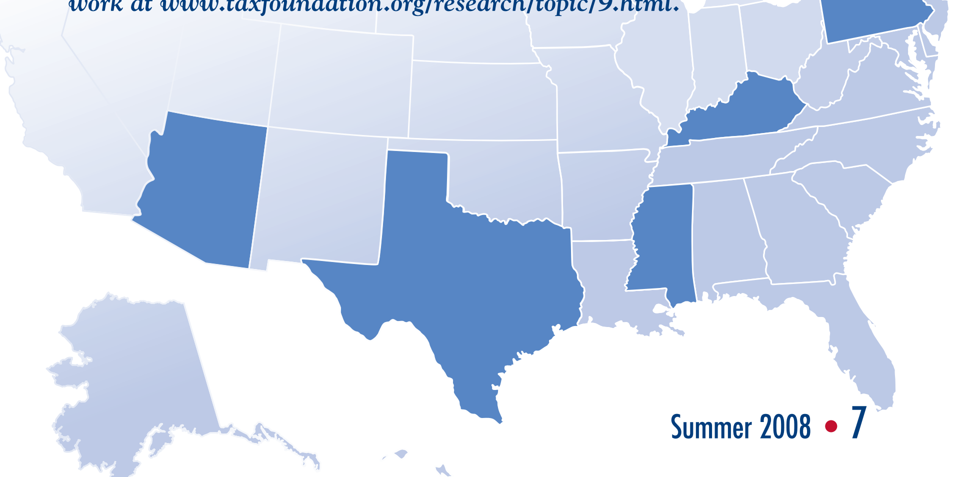
Tax Foundation experts Tonya Barr (left) and Joseph Henchman (third from left) advised Mississippi lawmakers on tax reform in March.

Mississippi: In March, Henchman and Manager of State Relations Tonya Barr attended a meeting of the forty-member Mississippi Tax Study Commission. Henchman testified on problems with Mississippi's tax system and outlined sixteen ways to improve its competitiveness.

Arizona: Senior Economist Gerald Prante was the keynote speaker at a May luncheon co-hosted by the Goldwater Institute and the Arizona Free Enterprise Club. Approximately ten lawmakers participated, as well as businesspeople, activists and others.

Texas: In May, Scott Hodge was invited by the Texas Public Policy Foundation to speak about the controversial new Texas margin tax, which threatens the state's business competitiveness.

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



Help Support Sound Tax Policy

Since 1937 the Tax Foundation has monitored America's tax policies, and our research and educational efforts on the economic impact of government 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.

Our work would not be possible without the generosity of supporters like you. 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.

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