



June 9, 2005

## **Number of Americans Outside the Income Tax System Continues to Grow**

by Scott A. Hodge and Patrick Fleenor

One of the biggest obstacles facing President Bush's Advisory Panel on Federal Tax Reform is the fact that America has become divided between a growing class of people who pay no income taxes and a shrinking class of people who are bearing the lion's share of the burden.

Despite the charges of critics that the tax cuts enacted in 2001, 2003 and 2004 favored the "rich," these cuts actually reduced the tax burden of low- and middle-income taxpayers and shifted the tax burden onto wealthier taxpayers. Tax Foundation economists estimate that for tax year 2004, a record 42.5 million Americans who filed a tax return (one-third of the 131 million returns filed last year) had no tax liability after they took advantage of their credits and deductions. Millions more paid next to nothing.

As Figure 1 and Table 1 show, the number of number of Americans who paid no income taxes because of the preferences in the tax code has varied greatly since 1950. While the number of these "non-payers" has averaged about 22 percent of all filers over the past five decades, it has spiked to record levels in recent years and the trend line does not appear to be slowing.

**Figure 1. Percentage of Tax Filers Who Owe  
Zero Tax Liability, 1950-2004\***

**Table 1. Number of Tax Filers with Zero Tax Liability,  
1950-2004**

Year	Total Tax Returns Filed	Tax Returns with Zero Tax Liability	Percentage of Tax Returns with Zero Tax Liability
1950	53,060,098	14,873,416	28.0%
1951	55,447,009	12,798,399	23.1%
1952	56,528,817	12,652,544	22.4%
1953	57,838,184	12,615,033	21.8%
1954	56,747,008	14,113,948	24.9%
1955	58,250,188	13,561,123	23.3%
1956	59,197,004	12,938,358	21.9%
1957	59,825,121	12,959,806	21.7%
1958	59,085,182	13,433,048	22.7%
1959	60,271,297	12,774,384	21.2%
1960	61,027,931	12,966,946	21.2%
1961	61,499,420	12,916,655	21.0%
1962	62,712,386	12,620,023	20.1%
1963	63,943,236	12,620,015	19.7%
1964	65,375,601	14,069,263	21.5%
1965	67,596,300	13,895,506	20.6%
1966	70,160,425	13,451,349	19.2%
1967	71,651,909	12,978,971	18.1%
1968	73,728,708	12,440,000	16.9%
1969	75,834,388	12,112,994	16.0%
1970	74,279,831	14,962,460	20.1%
1971	74,576,407	14,660,035	19.7%
1972	77,572,720	16,703,713	21.5%
1973	80,602,587	16,425,425	20.4%

1989	112,135,673	22,957,318	20.5%
1990	113,717,138	23,854,704	21.0%
1991	114,730,123	25,996,536	22.7%
1992	113,604,503	26,872,557	23.7%
1993	114,601,819	28,166,452	24.6%
1994	115,943,131	28,323,685	24.4%
1995	118,218,327	28,965,338	24.5%
1996	120,351,208	29,421,858	24.4%
1997	122,421,991	28,950,791	23.6%
1998	124,770,662	31,722,764	25.4%
1999	127,075,145	32,529,065	25.6%
2000	129,373,500	32,555,897	25.2%
2001	130,255,237	35,491,707	27.2%
2002	130,076,443	39,112,547	30.1%
2003	130,571,319	41,467,439	31.8%
2004*	131,113,969	42,545,501	32.4%
* Estimated.			
Source: IRS, Tax Foundation Individual Tax Model			

In addition to these non-payers, roughly 15 million individuals and families earned some income last year but not enough to be required to file a tax return. When these non-filers are added to the non-payers, they add up to 57.5 million income-earning people who will be paying no income taxes.

Even 57.5 million is not the actual number of people because one tax return often represents several people. When all of the dependents of these income-producing people are counted, roughly 120 million Americans – 40 percent of the U.S. population – are outside of the federal income tax system.

In 1997, Congress enacted a new \$500 per-child tax credit and expanded the Earned Income Tax Credit (EITC) for low-income workers. The 2003 tax cuts increased the value of the child credit to \$1,000. These two tax credits – especially the child credit – have had a powerful effect on reducing, and many cases eliminating, the income tax liability for millions of Americans.

These two credits are unique in that a taxpayer can receive the full value of the credit even if they have no tax liability. To see how this works, consider, for example, a family that has three children (and thus should receive \$3,000 in tax credits), but only has a tax liability of \$1,505. Under the rules of most tax credits, this family would only be allowed \$1,505 in tax relief – an amount equal to their tax liability. But a “refundable” tax credit gives this family the full amount they are eligible for -- \$1,505 toward their tax liability, and the remaining \$1,495 in the form of a refund check. (See Table 2.)

<b>Table 2. How “Refundable” Tax Credits Work</b>	
Married Couple with Three Children	Tax Liability Under 2004 Tax Law
<b>Adjusted Gross Income in 2004</b>	<b>\$40,000</b>
Minus Standard Deduction	-\$9,700
Minus Personal Exemption	-\$15,500
Taxable Income	\$14,800
<b>Gross Taxes Owed</b>	<b>\$1,505</b>
Minus 3 Child Credits	-\$3,000
<b>Taxes Owed</b>	<b>\$0</b>
"Refundable" Credit Received	\$1,495

Of the 42.5 million tax returns that pay no income taxes, 52.9 percent received some form of a refundable credit – either the EITC or the child tax credit. In 2004, Uncle Sam paid

**Table 3: Demographic Profile of Zero-Tax Filers and Non-Filers**

	Distribution of 42.5 Million Non- Paying Filers	Distribution of 15 Million Non-Filers	Distribution of Combined 57.5 Million Zero-Tax Population
Income			
\$1--\$29,999	90.8%	98.9%	92.9%
\$20,001--\$39,999	5.2%	0.6%	4.0%
\$40,000--\$74,999	3.7%	0.5%	2.9%
\$75,000+	0.24%	0.02%	0.2%
Age			
<18--24	34.9%	9.9%	28.4%
25--34	18.6%	7.7%	15.8%
35--44	20.7%	9.7%	17.8%
45--54	10.8%	10.0%	10.6%
55+	15.0%	62.8%	27.5%
Race or Ethnicity			
White	79.4%	75.2%	78.3%
African American	16.3%	20.1%	17.3%
American Indian	1.2%	1.3%	1.2%
Asian America	3.2%	3.4%	3.2%
[Hispanic American]	[14.0%]	[11.5%]	[13.5%]
Gender of Major Earner			
Male	46.0%	37.4%	43.8%
Female	54.0%	62.6%	56.2%

## **Income**

The 42.5 million non-payers are largely low-income. Indeed, 91 percent of them earned less than \$30,000 per year and 96 percent earned less than \$40,000. Fewer than 1 percent will earn more than \$75,000 per year – a group comprised largely of business owners whose tax liabilities will be erased due to business losses, carry-overs from prior year AMT payments, or foreign tax credits.

## **Age**

Non-payers in 2004 were overwhelmingly young. Looking at the age of the primary breadwinner on these tax returns, only 26 percent are 45 years old or older. More than one-third (35 percent) are younger than age 25, and 54 percent are younger than age 35. Interestingly, there is a significant cluster of households (20.7 percent) where the principal wage earner is between the ages of 35 and 44. Most likely, these are modest-income families who benefited most from the doubling of the value of the child credit to \$1,000 and were, thus, pushed into the non-payer status.

## **Race or Ethnicity**

The racial or ethnic composition of the 42.5 million non-payers roughly mirrors the demographics of American tax filers as a whole. For example, white Americans are 83 percent of total taxpayers, and the percentage of zero-tax filers who are white is 79 percent. African Americans are roughly 13 percent of total taxpayers and 16 percent of zero-tax filers. Asian Americans comprise 3.6 percent of total taxpayers and 3.2 percent of zero-tax filers.

That said, the percentage of non-payers within each ethnic or racial group does vary: 28.6 percent of Asian Americans tax filers get back every dollar withheld, 31.1 percent of white American tax filers will owe nothing, and 41.7 percent of African Americans will file a tax return with no liability.

Absent from these categories are Hispanic Americans. Within Census data, race and

percent of all tax returns. Married couples comprise just 27.7 percent of tax returns with no income tax liability.

### **Work Status**

Non-payers tend to be low-income, working part-time or full-time for only part of the work year. Indeed, 45.5 percent will be working part-time or hardly at all, while another 20 percent are working full time but less than 50 weeks out of the year. Indeed, 7.5 million of these individuals who file a tax return earn less than the threshold amount for filing a tax return, but do so just to recover the amount of taxes that were withheld during the course of their part-time employment. Just 34.6 percent of zero-tax filers worked full-time for all of 2004.

### **Occupation**

The occupations of non-paying tax filers are difficult to generalize because of the large number of categories government statistics tend to group them in. However, due again to their young age, 24 percent of these filers are classified as "children" or "students" rather than their occupations. The other leading occupational categories are "other services" (16.6 percent), "administrative support" (11.2 percent), "sales" (11.0 percent), and "precision production" (7 percent).

### **Who Doesn't Have to File?**

Americans are required to file a tax return if their income is over a certain amount. For single individuals under 65, that amount was \$7,950 in 2004. For those 65 or older, the amount was \$9,150 (Social Security benefits are not included). Married couples must file if their gross income is at least \$15,900 (\$17,800 for couples over age 65). Heads of households (single parents) must file if they earn at least \$10,250.

Broadly, people who did not earn enough to file a tax return for 2004 ("non-filers") are college students, retirees, and single parents. They have part-time jobs but earn less than the minimum amounts that are required to file a tax return.

When we combine the populations of non-payers and non-filers and look to see what overall percentage of each group is not paying taxes, we find that: 50.7 percent of African American households pay no income taxes, 35.5 percent of Asian American households do not, 37.6 percent of White American households do not, and roughly 52 percent of Hispanics pay no income taxes.

### **Gender**

Among the population of non-filers, female-headed households are even more dominant. Roughly two-thirds of these households are headed by women, whereas 37 percent are headed by men.

### **Work Status**

Not surprisingly, 93 percent of non-filing households are considered non-workers – meaning they worked less than 13 weeks out of the year. Only 1.46 percent of non-filers will have worked full-time during 2004.

### **Conclusion**

In 2004, a record 42.5 million tax returns – one-third of all returns filed – had no income tax liability because of the available credits and deductions in the tax code. This is a 42 percent increase in the number of zero-tax filers in just four years. In addition to these zero-tax filers are the 15 million individuals or households who do not earn enough to file a tax return. Overall, nearly 58 million taxable households are outside of the income tax system.

These findings raise serious questions about the future of the U.S. income tax system. Are any future tax cuts, or even tax reforms, possible when the lion's share of the tax burden is increasingly borne by a shrinking pool of taxpayers who – at least on paper – appear to be "upper-income"? And will the expanding pool of non-payers demand even higher income taxes? These are questions lawmakers must begin to debate.