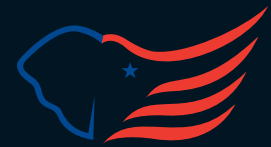
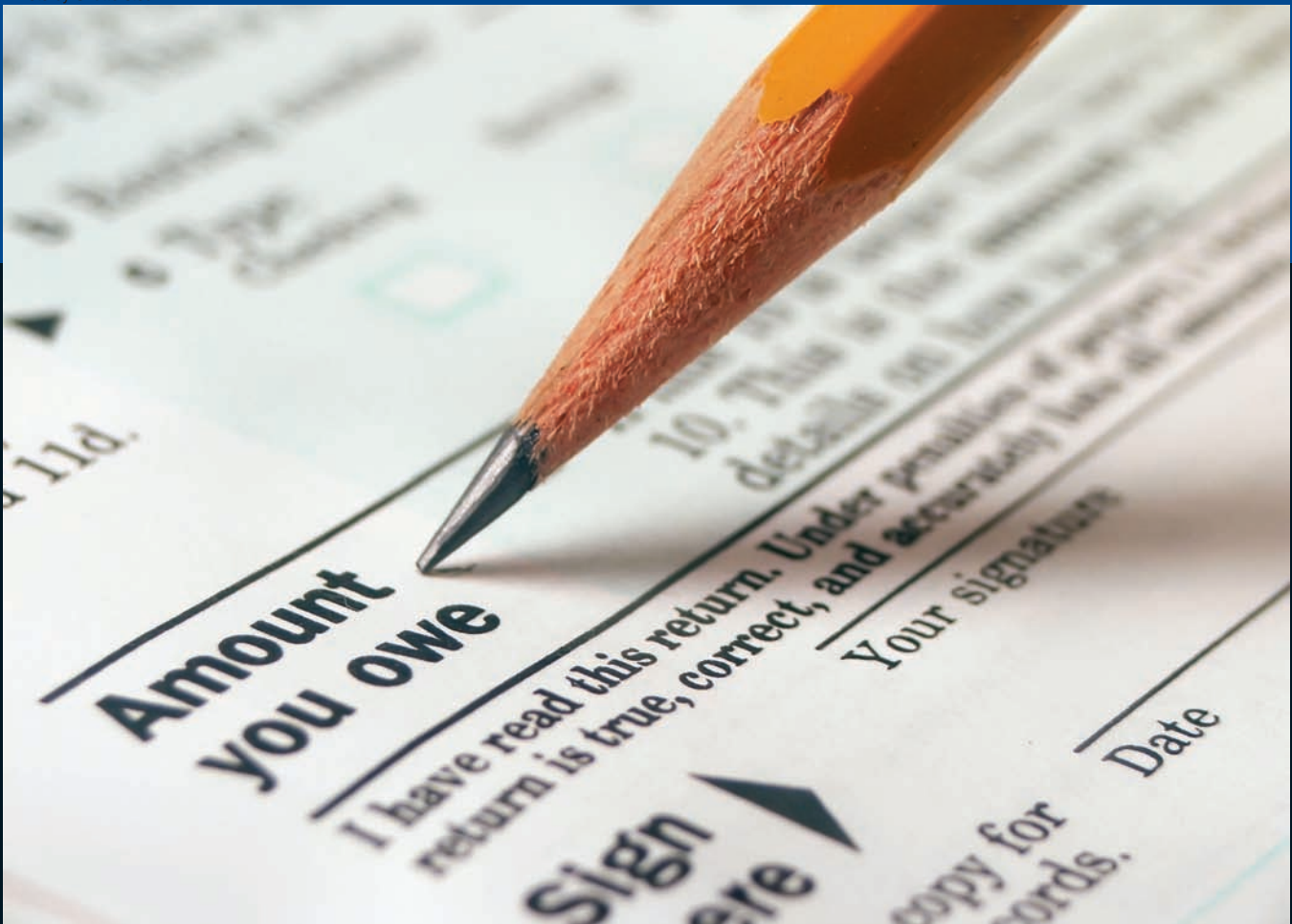


Taxation: The Changing Average American Tax Payer

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U.S. Representative Jim McCrery The Alternative Minimum Tax Debate

It is somewhat difficult to write this piece. As I write, it is a week or two before the House Democrats will introduce legislation to change the Alternative Minimum Tax (AMT), which I expect will be the dominant tax issue of this year - and perhaps this Congress. By the time you read these words, I expect we will be in the midst of a serious debate over the Democratic proposal. It is clear that the Democrats' proposal to modify the AMT is unlikely to become law this year - they as much as conceded that by including a one-year patch in their budget last month. If the expected Democrat AMT bill clears the House, it will find little enthusiasm in the Senate and an almost certain veto from the White House. However, this issue will come up again, most likely, in my opinion, in 2009, when we will face a "perfect storm" that could create conditions for fundamental tax reform.

The AMT is an inefficient parallel tax system. Under the law, taxpayers must calculate their regular tax burden, then calculate what they owe under the different rate and exemption structure of the AMT, and then pay whichever is higher. It was created in the late 1960s by Democrats outraged by reports that a small number of wealthy Americans were using tax deductions to avoid paying any tax at all. The problems with the AMT were exacerbated in 1993, when President Clinton raised the AMT rates and failed to index them for inflation. Over the past two decades, a form of "bracket creep" has led to many middle class families (particularly in areas with high local taxes) being subject to the AMT.

Republicans voted to abolish the AMT in 1999, but President Clinton vetoed the bill. In recent years, Republicans have led annual efforts to protect the middle class from the AMT's expansion using a series of one-year patches. While the patches have prevented the AMT from spreading, the underlying cost of dealing with the problem has grown dramatically. Eliminating it is now estimated to cost nearly \$900 billion over the next ten years. If the patch is not extended, the AMT will hit about 23 million taxpayers next year, compared to roughly 4 million in tax year 2006. Because of the patch, most of these taxpayers have no idea that - under current tax law - they will be paying the AMT next April.

Remember that I am writing this before I see the Democrats' proposal. But I expect - based on press reports - they will seek to eliminate the AMT burden for taxpayers earning under \$250,000 (who generally do not know they are "supposed" to be paying the AMT) by imposing substantial tax increases on taxpayers with higher levels of income - including small business owners and farmers, who often file their business income on personal tax forms. This new tax increase would be on top of the expiration of the 2001 and 2003 Republican tax cuts. That tax increase, which will cost the American people at least \$217 billion in higher taxes over five



years, is already "baked in the cake" - it was included in the Democrats' budget.

That approach would be the wrong direction for American tax policy. Just for example, if Democrats were to pay for their AMT plan simply by raising the top income tax rate, that rate would jump from 35 percent today to nearly 50 percent. That is basically the same top tax rate as France. At a time when the new French President says that he wants tax cuts to jump-start that nation's sluggish economy, why should America raise our tax rates to France's level?

I believe Congress will reject that anti-growth, anti-jobs approach. What is more likely, in my opinion, is that we will kick the can down the road by extending the "patch" for an additional year or two. That will bring us to 2009, which is the best opportunity I can see for fundamental tax reform. The pending expiration of the '01 and '03 tax cuts, plus the ever-increasing problem of the AMT, will create a problem so big and so expensive that it can only be addressed in the context of a major overhaul of our tax system.

I don't know yet what that overhaul will look like. There are a number of options we can consider, but clearly we can come up with a system that is clearer and fairer, and encourages growth and job creation in our economy. I look forward to working toward that goal.

— *U.S. Representative Jim McCrery is in his 11th term representing Louisiana's 4th District. He is the Ranking Member on the House Ways and Means Committee and serves on the Joint Committee on Taxation.*

Today's Middle Class Is Not Our Father's Middle Class

Scott A. Hodge

In Washington, every tax discussion begins with the premise that tax policies should either help or at least protect the “middle class.” And by middle class, most politicians tend to talk about the median taxpayer or those in the statistical middle – taxpayers earning between roughly \$25,000 to \$45,000 per year.

However, this portrait of middle class families is about as obsolete as are the vacuum tubes that used to power my grandfather's television. As a result, a lot of tax policies these days are as misguided as trying to use rabbit ears on your high-definition television.

If by “middle class” we mean intact families with children (the stereotypical family of four), then these families no longer comprise the majority of the statistical middle 20 percent of taxpayers. The majority of families with children now populate the wealthiest 40 percent of Americans, in part because of the growth in dual-earner households. So if members of Congress focus too much on helping the “median taxpayers” they will not help the majority of today's working families.

Figure 1 on the next page looks at the composition of taxpayers in 1960, back in the days of “Leave it to Beaver.” The population of taxpayers is divided evenly into five equal parts, or quintiles, each with 20 percent of taxpayers. Focusing specifically on the middle quintile, we can see that the stereotype was true: nearly 70 percent were married couples, most of whom were raising children. Indeed, in 1960, married couples comprised the majority of every group of taxpayers except for the lowest 20 percent. Of that low-income group, 73 percent were single filers.

Over the past four decades, demographic changes have dramatically altered the picture of the statistical middle and contributed to the perception of widening income disparity in America. This contrast can be seen in Figure 2 (Page 26). One of the biggest of these changes has been the rise of dual-income families. In the mid-1960s, less than half of all working-age families – 38 percent – had both spouses in the workforce. Today, some 67 percent of families have both spouses in the workforce and only 21 percent have only one spouse working.

One of the most important things that Washington can do for today's working families is to demand less of them.

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Phoebe and Joey Have Replaced June and Ward

Today, the composition of taxpayers in the statistical "middle class" is completely reversed from what it was in 1960. More than two-thirds of modern middle-income taxpayers are single, or single-headed households, while just 36 percent are married. In other words, the statistical middle now looks more like the cast of the TV program "Friends," not the "June and Ward Cleaver" notion that many of us grew up with.

Moreover, while half of the middle-income taxpayers in 1960 were couples with children, today only 18 percent of these taxpayers are couples with children. The majority of couples with children are now clustered in the top two quintiles.

These demographic shifts have no doubt contributed to the perception of rising income inequality. When the so-called rich are increasingly couples with two incomes, they will naturally look wealthier than the vast number of single taxpayers who now populate the statistical middle.

However, when two single workers get married, they may immediately move from the statistical middle to the so-called "rich" simply by saying, "I do."

For example, a young school teacher earning \$40,000 per year clearly falls into the statistical middle. But if she marries a man earning the same amount as a computer technician, their combined income of \$80,000 is enough to qualify them to be in the top 20 percent of tax returns. Thus a family can have two "middle-class" jobs with two middle-income salaries, but still be considered statistically high-income according to sterile IRS data.

Taxes are stressing these dual-earner families from all sides. Many of these families live in high-cost urban and suburban areas and have incomes commensurate with the cost of living. Because of the progressive rate structure of the federal tax code, these couples end up facing the highest federal income tax rates even though they live distinctly "middle-class" lifestyles. For example, a couple earning \$150,000 may be considered rich in Lincoln, Nebraska, but are considered middle-income in Westchester, New York. They both, however, are theoretically taxed at the same marginal tax rate.

These dual-income couples also tend to live in communities with high state and local taxes – especially property taxes. As a result, they are increasingly subjected to the Alternative Minimum Tax, which increases their federal tax bills.

As lawmakers look for solutions to the economic challenges facing today's "middle-class" but upper-income families, they would do well to consider the way in which taxes – federal and local – are contributing to their economic problems.

Working Families Bear the Nation's Tax Burden

One of the most important things that Washington can do for today's working families is to demand less of them. Upper-income

working families are now paying the lion's share of the nation's tax burden and getting little in return. Indeed, a new Tax Foundation study shows that these taxpayers are not only paying their share of the tax burden but they are pulling the wagon for millions of their fellow Americans.

Over the past quarter-century, federal tax policy – and income tax policy in particular – has shifted the burden of taxation to

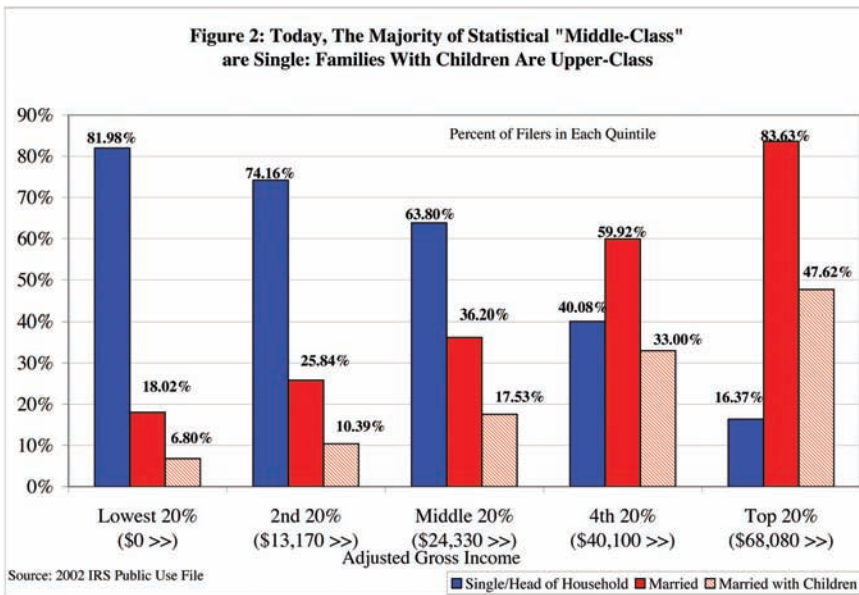
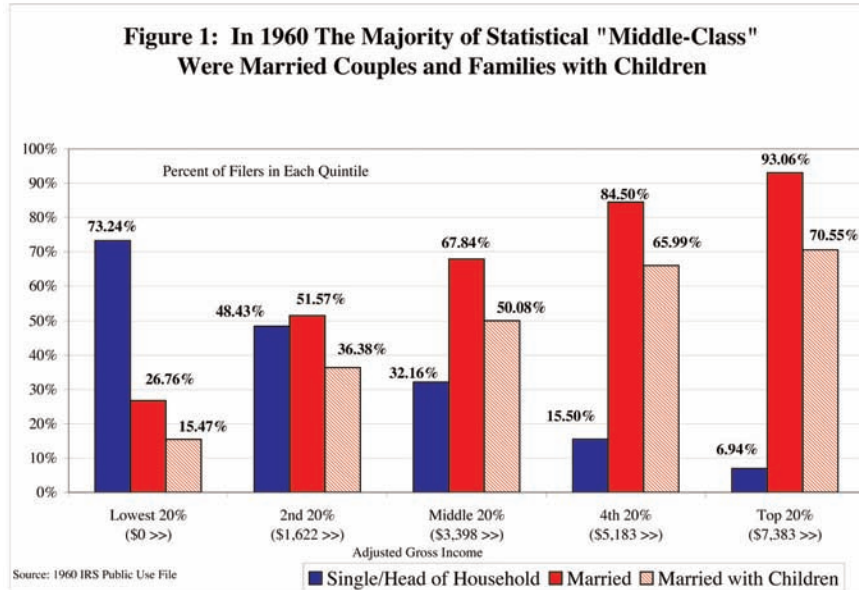




Photo by Getty Images.

upper-income Americans even as overall tax rates have been cut substantially. While cutting top rates, lawmakers enacted numerous measures that have effectively knocked millions of taxpayers off the rolls entirely.

Today, some 44 million Americans, one-third of all tax filers, file a tax return but have no income tax liability after taking advantage of credits and deductions such as the Earned Income Tax Credit and the \$1,000 child credit. The number of non-payers has increased by 50 percent since 2000 when the number of filers with zero tax liability stood at 29 million. Added to these non-payers are 15 million people who have some income but not enough to file a tax return. This brings the total of households outside of the income tax system to 58 million.

Moreover, lawmakers are increasingly involving the IRS in the distribution of benefits to low-income taxpayers. Last year, the IRS sent out \$50 billion in refundable credits through the Earned Income Tax Credit program (\$35 billion) and the child credit (\$15 billion). These payments effectively offset other taxes that these low-income families pay, such as payroll and excise taxes.

As the result of so many taxpayers being knocked off the bottom, the top 20 percent of taxpayers – which is largely composed of dual-income families – now pays 84 percent of the federal income tax burden. The top 10 percent (those earning over roughly \$99,000) pay about 68 percent of income taxes.

Indeed, the income tax code has become so progressive that the top 1 percent of taxpayers alone – largely the nation's entrepreneurs – now pays 37 percent of income taxes even though they comprise 19 percent of the nation's income. This is a greater share of the income tax burden than is borne by the bottom 90 percent, representing about 115 million taxpayers. This means that the top 1.5 million taxpayers pay a greater share of income taxes

than everyone earning under \$100,000 per year combined.

Who Pays and Who Receives?

What is more surprising is the amount of income that is being redistributed from upper-income households to lower-income households. A new Tax Foundation study, "Who Pays America's Tax Burden, and Who Gets the Most Government Spending?" compares the amount of taxes paid by households to the amount of spending they receive from government.

The Tax Foundation study shows that the spending side of the government ledger, especially federal spending, is also quite progressive or "pro-poor." In 2004, governments at all levels spent roughly \$3.5 trillion on American households – or roughly \$31,108 for every household in the country. Of that amount, \$2.2 trillion was spent by the federal government and \$1.3 trillion was spent by state and local lawmakers.

Using official survey data from the federal government, Tax Foundation economists were able to determine which households



Photo by Getty Images.

Today's Middle Class Is Not Our Father's Middle Class

in America are most likely to use all the different government programs on the books – from local roads to federal tuition subsidies – and allocate the costs to those who use them.

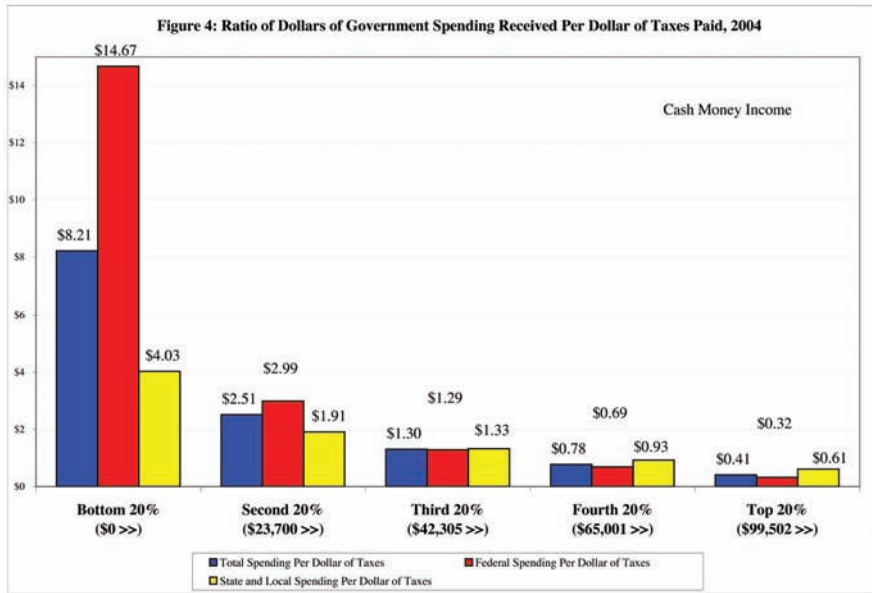
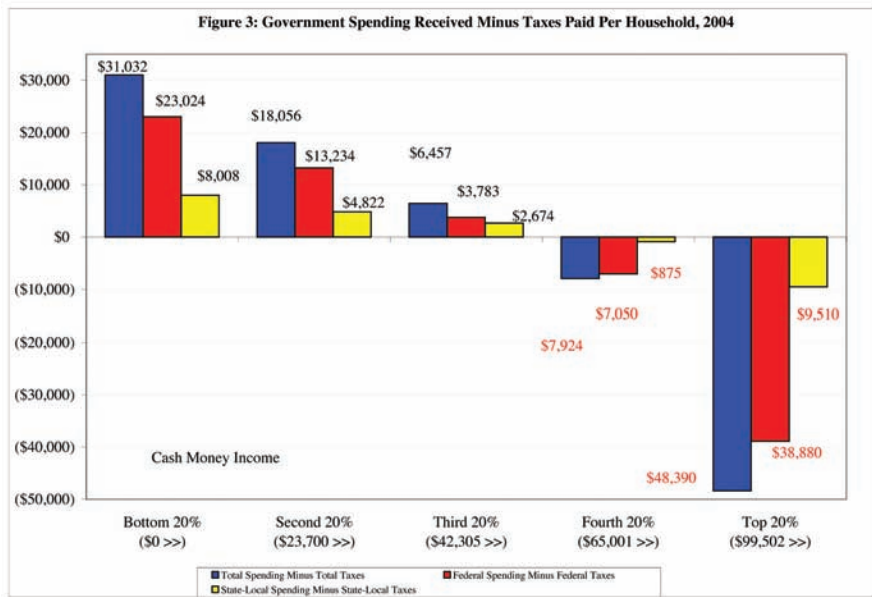
The spending received by each household was then compared to the total amount of taxes it paid – from local property taxes to federal income taxes. If a household receives more in government spending than it pays in taxes it is considered a net consumer of government, while households who pay more in taxes than they receive in spending are considered to be net payers.

The result of this comparison will surprise many Americans. Figure 3 shows the net amount of spending households receive compared to the taxes they pay. Overall, households in the bottom 20 percent receive \$31,032 more in government spending than they pay in taxes. Households in the middle 20 percent, so-called “middle-income,” receive \$6,457 more in spending than they pay in taxes, while households in the top 20 percent pay an average of \$48,390 more in taxes than they get in government spending.

Figure 4 displays the ratio of how much government spending households receive compared to the amount of taxes they pay. Looking specifically at the ratio of federal taxes and spending shows that the lowest 20 percent of Americans receive \$14.67 in spending for each \$1 they pay in taxes. Households in the middle-income range receive \$1.29 per tax dollar, and America's highest earning households receive \$0.32 per tax dollar.

Clearly, the bottom 60 percent of households on average get more government spending than they pay in taxes. And this is funded entirely by households in the top 40 percent. In all, government in 2004 redistributed \$1 trillion to \$1.5 trillion from the top 40 percent to the bottom 60 percent of households through taxes and spending. That's between 9 percent and 13 percent of the total GDP in that year.

The fact that the majority of Americans are now net consumers of government spending while a minority are net funders of government should be a cause for alarm, especially since that tax-funding minority is largely comprised of dual-income working families and entrepreneurs. Not only are we asking too much of them, but we are setting the stage for social conflict between those who consume government and those who pay for government.



Help Working Families by Doing Less

While it is tempting for lawmakers to try to do more for working families through new tax and spending initiatives, Washington can actually do more for them by doing less. Frankly, we are already asking too much of the IRS and the tax system and neither one is functioning very well.

Lawmakers are increasingly asking the tax code to direct all manner of social and economic objectives, such as encouraging people to: buy hybrid vehicles, save more for retirement, purchase health insurance; buy a home, adopt children, put them in daycare, take care of grandma, hire the unemployed, spend more on research, purchase school supplies, take out huge college loans, invest in historic buildings, and the list goes on. The point is that we have so carved up the tax base that trying to accomplish more social goals via the tax code will be like pushing on a string.

Interestingly, the issues that are most troubling for working families – health care, housing, education, and property taxes – are the areas in which government is already the most involved.

For example, the tax preference for employer-provided health insurance creates a classic third-party payer problem in which patient-consumers are disconnected from the cost of service. The cost of health care is soaring because we have an unlimited demand for health care because someone else is paying the bills. The market forces that deliver quality goods at low prices for everything from toasters to automobiles have been disrupted in the health care system because it is tax preferred.

Higher education suffers a similar problem because of the plethora of tax and spending subsidies for college costs. Universities don't have an incentive to control costs because they know students aren't bearing the full cost. And efforts to help students with tax credits backfire because the credits ultimately get capitalized into the price of tuition in the same manner that the Mortgage Interest Deduction gets capitalized into the price of homes.

The deduction for state and local taxes allows local governments to raise taxes and pass as much as one-third of those costs to Uncle Sam. This is especially true for high-cost, high-tax suburban communities. Ironically, the state and local tax deduction is the primary reason more and more taxpayers in these high-tax urban areas – largely in so-called Blue States – are being ensnared in the Alternative Minimum Tax. The AMT is not an issue for taxpayers in lower-tax states and communities.

Taxpayers Support Simple System and Low Rates

The most recent Tax Foundation *Annual Survey of U.S. Attitudes on Taxes and Wealth*, conducted by Harris Interactive®, finds that the majority of U.S. adults believe the federal tax code is complex, the federal income tax taxes they pay are too high, and the federal tax system needs major changes or a complete overhaul. Surprisingly, half of those surveyed would give up some tax deductions in exchange for lower tax rates.

Ideally, eliminating tax preferences should be accompanied by an across-the-board reduction in tax rates. A bit of sugar always helps the medicine go down and polls show that taxpayers are largely supportive of this approach to tax reform.

As a thought experiment, Tax Foundation economists used our tax model to calculate how low tax rates could be cut by broadening the tax base through the elimination of various tax preferences. These include the preference for state and local bonds, the Mortgage Interest Deduction, the state and local tax deduction,

and the tax exclusion for employer-provided health care. While seemingly painful, eliminating these preferences allows for a 32 percent across-the-board cut in every marginal tax rate. This means the 10 percent rate would fall to 6.79 percent and the top rate would fall to 23.76 percent.

Avoid Policies that Are Harmful to Working Families

The Bush tax cuts expire at the end of 2010 and many in Washington are of the opinion that most of the provisions – especially the top tax rates – should be allowed to expire and return to their higher 2000 levels. For example, the top individual rate of 35 percent would increase to 39.6 percent.

Our research suggests that raising the top income tax rates would not likely stop the vast demographic changes that are affecting the distribution of income and taxes in America. We know that taxpayers affected by the highest tax rates are largely dual-income, college educated, older and in their peak earning years, and have business

income. Are these not qualities we want to encourage, not discourage?

Similarly, there is growing sentiment that the lower rates on capital gains and dividend income should be raised to the level of the individual rates. But the evidence suggests that boosting capital gains and dividend income would harm American competitiveness and well as the growing number of retirees who depend upon this income.

Those who want to tax capital income and wage income at the same rate seem to forget that capital income is taxed twice, first at the corporate level – at 35 percent – and then again at 15 percent at the individual level. Capital taxes at the state level add yet another layer.

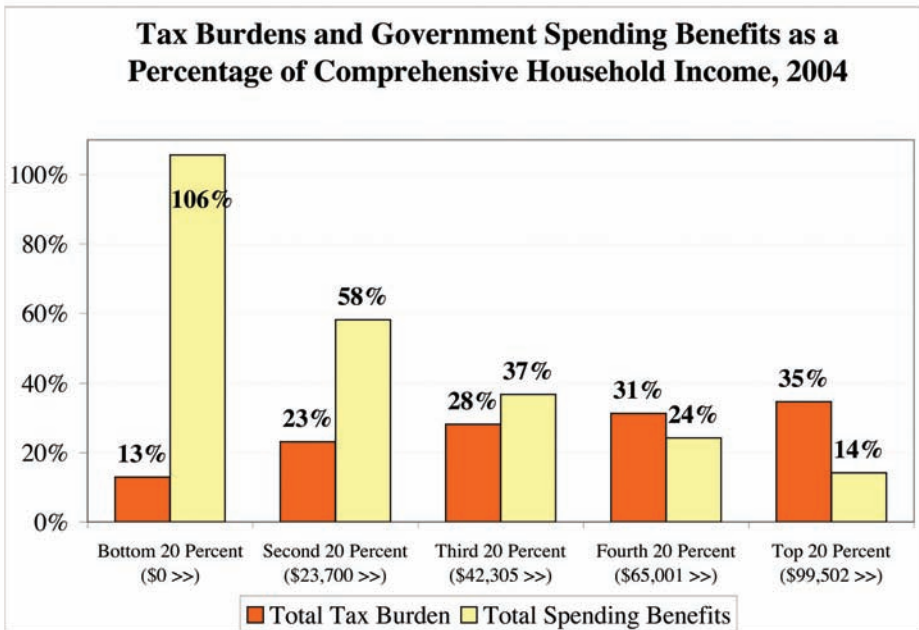
Data from the OECD shows that the U.S. has a combined rate of 50.8 percent on dividend income, ranking our rate as the eighth highest among developed countries and six percentage points higher than the OECD average. Boosting our rate not only flies in the face of global trends in capital taxation, but it will make U.S. companies less competitive in the global capital market by encouraging investors to put their money in lower-tax countries.

As America becomes a nation of investors, older Americans are more and more reliant on capital gains and dividend income. The data shows that capital gains realizations clearly increase with age. Some 30.2 percent of taxpayers between age 65 and 74 claim capital gains income, while 27.6 percent of taxpayers over age 75 have capital gains income.

The majority of families with children now populate the wealthiest 40 percent of Americans, in part because of the growth in dual-earner households.

Today's Middle Class Is Not Our Father's Middle Class

When two single workers get married, they may immediately move from the statistical middle to the so-called "rich" simply by saying, "I do."



Older Americans are even more reliant on dividend income than capital gains. Among taxpayers between age 65 and 74, a remarkable 51.3 percent claim dividend income while 50.4 percent above age 75 have dividend income.

Considering America's demographic changes, raising the capital gains and dividend taxes at this time would have a severe impact on the soon-to-be-retiring Baby Boomer generation in addition to current retirees.

income, educated, older, and business owners – all traits we should value and not punish through punitive tax rates and redistribution.

Our government's attempt to use tax policy to help certain sectors of the economy over others has not only produced a Byzantine tax system, but it has also created economic distortions in the very areas we have tried to help such as housing, health care, and education.

The way to help middle-class families is to do less. Greatly simplifying the tax code while cutting tax rates across the board would boost economic growth and, most likely, also boost the incomes of all working families. This is an outcome that should attract bipartisan support. ☺

— Scott A. Hodge is the President of the Tax Foundation.

Conclusion

Public opinion polls universally indicate that the vast majority of Americans view themselves as "middle-class." Indeed, a recent Tax Foundation public opinion survey found that only 2 percent of adults identified themselves as "upper-class." These surveys make it clear that most Americans see the concept of "middle-class" as a value system, not a point on the income scale.

The key to helping the so-called middle-class while solving the inequality problem is to implement policies that make all Americans richer, not try to bring the top back down to the middle. Our attempts to promote equality should not produce mediocrity.

Today's middle-class families are not our fathers' middle class. Today's working couples with children are increasingly dual-



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