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The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW
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PRESIDENT'S ADVISORY
PANEL
ON FEDERAL TAX REFORM
2005 APR - 6 A 9: 50

Dear Panel Members,

Please accept the enclosed comments proposing fundamental tax reform from Scott A. Hodge, President, Tax Foundation. We appreciate this opportunity to provide our input—please feel free to contact me at (202) 464-6200 with any questions.

Sincerely,

Andrew Chamberlain
Staff Economist

THE CASE FOR A SINGLE-RATE TAX:
WHY OUR PROGRESSIVE TAX CODE IS INCONSISTENT WITH
THE CHANGING FACE OF AMERICAN TAXPAYERS

COMMENTS SUBMITTED TO THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

BY SCOTT A. HODGE
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(CATEGORY: ORGANIZATIONS AND ASSOCIATIONS)

APRIL 29, 2005

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EXECUTIVE SUMMARY

Americans are ready to support fundamental tax reform, judging from their responses to a recent Tax Foundation/Harris Interactive poll. A majority of American adults believe federal taxes are too high, the tax code is too complex, and the income tax system is unfair. A majority even support simplification even if it means giving up some deductions and exemptions.

The first step toward a solution is to understand how our progressive income tax rate system interacts with recent demographic changes. If we look at who comprises the wealthiest 20 percent of taxpayers, we find they share many traits with our traditional notions of “middle class”:

- They are overwhelmingly dual-income married couples;
- They live in high-cost metropolitan areas and have correspondingly high nominal incomes, but average living standards;
- They are older workers, at or nearing their peak earning years;
- They are college educated and have professional jobs; and
- They have business income.

The current tax system penalizes these groups. These families are taxed at the highest income tax rates because our progressive tax rate system is not fully adjusted for such things as cost of living, age, education, or the number of incomes in a household. Tax reform should attempt to make the tax code more neutral to these demographic traits,

The only way to mitigate the punishing effects of our current progressive rate structure on dual-income couples, older workers, the college educated, business owners, and families living in high-cost communities, is to enact a single-rate tax levied on consumption or on incomes. Such a tax should be set a low rate, applied to a broad base, and have as few deductions as is politically possible. Single-rate tax systems have proven successful in Central and Eastern European countries in recent years, and would likely enjoy similar success in the United States.

INTRODUCTION

President Bush and the members of this panel should be commended for their efforts to develop viable proposals to reform the federal tax code. Americans are ready to support fundamental tax reform, judging from their responses to a recent Tax Foundation/Harris Interactive poll. A majority of American adults believe federal taxes are too high, the tax code is too complex, and the income tax system is unfair. A majority support simplification even if it means giving up the deductions and exemptions they now enjoy¹.

The biggest obstacle to reform may not be the army of Washington lobbyists who will fight to protect those deductions and exemptions. The most serious obstacle to 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, the tax cuts enacted in 2001, 2003 and 2004 dramatically reduced the tax burden of low- and middle-income taxpayers and shifted the tax burden onto wealthier taxpayers. In 2004, one out of every three Americans who filed a tax return (44 million) had no tax liability after they took advantage of their credits and deductions, while millions more paid next to nothing. As a result, the wealthiest 20 percent of taxpayers – those earning more than roughly \$68,000 in 2004 – now pay over 80 percent of all the income taxes.

The widening gulf between the “payers” and the “non-payers” poses a dilemma for this panel. Generally speaking, the goal of tax reform is to broaden the tax base while lowering tax rates. But how do you craft a tax reform plan that (1) doesn't raise taxes on the 44 million Americans who pay nothing – and in many cases receive a refundable credit – and (2) doesn't “cut taxes for the rich” who now pay everything? There is no easy answer.

¹ <http://www.taxfoundation.org/taxsurvey.html>

The first step toward a solution is to understand how our progressive income tax rate system is interacting with the demographic changes happening in America today. If we look at who comprises the statistically wealthiest 20 percent of taxpayers, we find that they are the picture of most any suburban family:

- They are overwhelmingly dual-income married couples;
- They live in high-cost metropolitan areas and have correspondingly high nominal incomes, but average living standards;
- They are older workers, at or nearing their peak earning years;
- They are college educated and have professional jobs; and
- They have business income.

In many areas of America, these taxpayers are “middle-class” by any standard. But these families are taxed at the highest income tax rates because our progressive tax rate system is not fully adjusted for such things as cost of living, age, education, or the number of incomes in a household. Unless we reform the tax code so that it is neutral to these demographic traits, America’s middle class may soon be the only “taxpayers” actually paying income taxes.

While no tax system can be fully adjusted for all of this nation’s vast differences, the most neutral system is a single-rate tax levied on consumption or on incomes above some pre-set level. Ideally, such a system should have as few deductions as possible and be applied to as broad a base as possible.

A TALE OF TWO AMERICAS: PAYERS AND NON-PAYERS

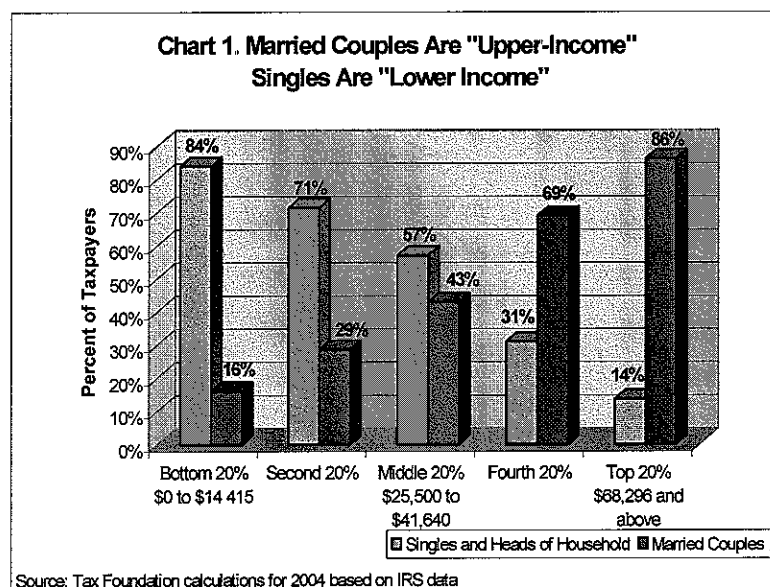
As this panel begins to develop reform plans for presentation to President Bush, some groups will urge you to “protect the middle class” from any change in the tax burden they already bear. By “middle class,” it is usually meant those taxpayers in the statistical middle 20 percent of the income scale – taxpayers earning between roughly \$25,000 and \$42,000 per year.

But in recent years the demographics of middle-income earners have shifted dramatically. The stereotype of “Ozzie and Harriet,” the married, single-earner family of the 1950s, is no longer typical in the middle one-fifth of the income scale. On the contrary, as Chart 1 shows, the middle one-fifth of the income scale looks more like the cast from the popular TV program “Friends.” More than half of those tax returns in the middle 20 percent are single individuals or single parents with children, not married couples with children. Today more than two-thirds of married couples are found in the top two income groups. The largest share of married couples – 35 percent – earn enough to be in the top 20 percent of taxpayers.

As Chart 1 clearly shows, nearly 9 out of every 10 taxpayers in the wealthiest 20 percent are married, and most of them are dual-income. It’s easy to see that with two incomes, working couples appear twice as wealthy. Over the past 15 years, the number of dual-income working couples has grown

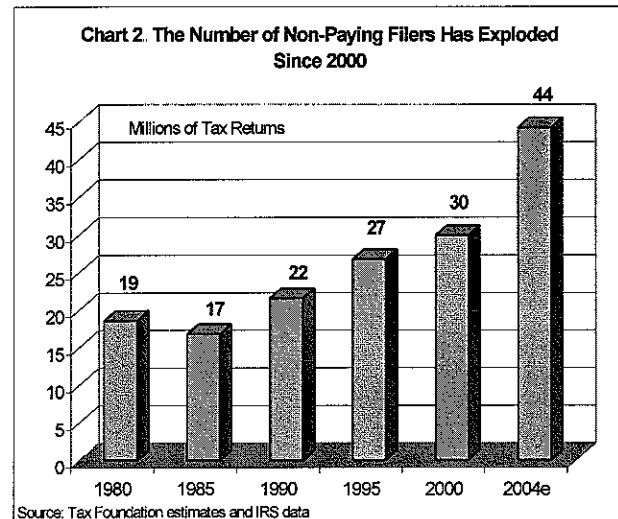
by more than 7 million to some 67 percent of working age couples.

For example, a young factory worker earning \$17 an hour – or \$35,000 per year – clearly falls into the statistical middle. But if she marries a man earning the same amount, their combined income of \$70,000 thrusts them well into the “wealthiest” 20 percent of Americans. Thus a family can have two middle-class jobs with two middle-class income salaries, but still be considered statistically rich according to IRS data.



Many of the tax cuts enacted over the past four years – specifically the doubling of the child credit to \$1,000 and the introduction of the new 10 percent bracket – were “targeted” to help taxpayers in the statistical middle class. It is unlikely that lawmakers understood how powerful these measures would be – not only lowering the tax burden for millions of lower- and middle-income taxpayers, but knocking millions of people off the tax rolls entirely – turning them into non-paying filers.

Tax Foundation economists estimate that in 2004, some 44 million Americans (one-third of all filers) filed a tax return but had no tax liability after taking advantage of their credits and deductions. As Chart 2 displays, this represents a nearly 50 percent increase in the number of non-payers since 2000 and a 160 percent increase since 1985².



WHO ARE THE NON-PAYERS?

Broadly speaking, non-payers are:

- Low-income: 97 percent earn less than \$40,000 annually;
- Young: 36 percent are younger than age 25 and 56 percent are younger than 35;
- Women and unmarried: 54 percent are single women or female-headed households;
- Part-time workers: 42 percent work part-time while just 20 percent work full-time but less than 50 weeks a year;
- Benefit from tax credits: 34 percent claim EITC while 50 percent claim the child credit.

² Hodge and Moody, www.taxfoundation.org/ff/zerotaxfilers.html

In addition to these non-paying filers, roughly 14 million individuals and families earned some income in 2004 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 58 million income-earning households who paid no income taxes last year.

Even 58 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 households are counted, roughly 122 million Americans – 44 percent of the U.S. population – are outside of the federal income tax system. Indeed, many of these households profit from the tax system through the refundable portions of the EITC and the child credit. In 2005, the Office of Management and Budget estimates that \$47 billion will be spent for refunds through these two programs.

While some may applaud the fact that millions of low- and middle-income families pay no income taxes, there is a threat to the fabric of our democracy when so many Americans are not only disconnected from the costs of government but are net consumers of government benefits. The conditions are ripe for social conflict if these voters begin to demand more government benefits because they know others will bear the costs.

The Tax Foundation/Harris Interactive poll found that 59 percent of American adults said it is unfair that 44 million Americans pay no federal income taxes after deductions and credits, and that everyone should be required to pay some minimum amount to fund government.

WHO PAYS THE INCOME TAXES IN AMERICA?

As we showed above, the vast majority of taxpayers who face the highest marginal tax rates tend to be dual-income working couples. But aside from being dual-income, they also tend to live in high-cost urban areas, they are older, they are college educated, and they are engaged in entrepreneurial activities. Each of these characteristics makes them more likely to be exposed to the highest marginal tax rates.

COST OF LIVING AND TAX BURDENS

Anyone who has faced a job transfer has had to come to grips with the fact that a dollar of income earned in one region of America does not always buy the same standard of living as a dollar earned in another region. Yet many of the rising class of dual-income professional couples live in high-cost urban areas and have income to match where they live. But the tax code doesn't account for this and these couples pay the price in higher taxes even though their standard of living may be no better than a similar couple earning thousands less in a lower-cost community.

To demonstrate how cost of living can affect a family's tax liability, Tax Foundation economists adjusted the income of a median, dual-income couple to various cities using the ACCRA cost of living index, one of the nation's leading providers of cost of living data. (Moody, <http://www.taxfoundation.org/costofliving.html>).

In 2004, the typical dual-income, childless married couple in America earned roughly \$74,443 – an income large enough to put them into the top 20 percent of taxpayers, with a tax liability of \$8,081 and an effective federal income tax rate of 10.4 percent. As it happens, the city with the closest average income to the national average is Milwaukee. (See Table 1.)

If that couple were transferred to New York City, they would need a joint income of nearly \$163,000 to maintain the same standard of living they had in Milwaukee. But this income thrusts them into the wealthiest 3 percent of taxpayers and boosts their tax liability to more than \$31,000 per year and their effective rate to 19.1 percent.

In terms of economic purchasing power, this illustrative couple has the same standard of living in each of these cities. But because our progressive tax rate structure is not adjusted to the varied cost of living throughout the United States, they face dramatically higher effective tax rates and tax payments simply by moving to a higher-cost metropolitan area.

Table 1. Cost of Living Has a Dramatic Impact on Tax Liability and Effective Tax Rates

Metro Area	The Income You Need to Buy Median Standard of Living*	Puts You in This Group of Taxpayers	With This Tax Liability in 2004	With This Effective Tax Rate
Houston	\$67,315	25%	\$6,999	10.4%
National Average (Milwaukee)	\$74,443	20%	\$8,081	10.9%
Orange County, CA	\$100,079	10%	\$14,506	14.5%
San Francisco, CA	\$135,003	5%	\$23,250	17.2%
New York City (Manhattan)	\$162,974	3%	\$31,139	19.1%

*Married Dual-Income Couple in 2004, No Children

While the tax code was indexed for inflation in 1985 to protect Americans from “bracket creep,” nothing is being done to protect them from “cost of living creep.” While the home mortgage interest deduction can provide some protection from rising housing costs, the Alternative Minimum Tax lessens some of that protection for families in these high-cost areas.

EDUCATIONAL ATTAINMENT AND TAXPAYER INCOMES

For most Americans, a college education is the ticket to a good job, a higher income, and a better standard of living. But a college education can also be the ticket to a higher tax rate. As Table 2 shows clearly, lower-income taxpayers have lower levels of educational achievement, while higher-income taxpayers have higher levels of educational achievement. Of those taxpayers in the lowest income group, 62 percent have a high school degree or less, while 28 percent have some college experience and just 10 percent have a bachelors degree or more. By contrast, among those taxpayers in the wealthiest 20 percent, more than 80 percent have some college education or better.

Table 2. College-Educated Workers Tend to Be High-Income Taxpayers

	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%
Less than High School	25.1%	15.9%	10.1%	5.9%	2.0%
High School Diploma	36.8%	40.0%	34.1%	30.6%	17.4%
Some College or Associate's	28.4%	30.0%	30.6%	30.1%	24.4%
Bachelor's or Above	9.7%	14.0%	25.2%	33.4%	56.2%

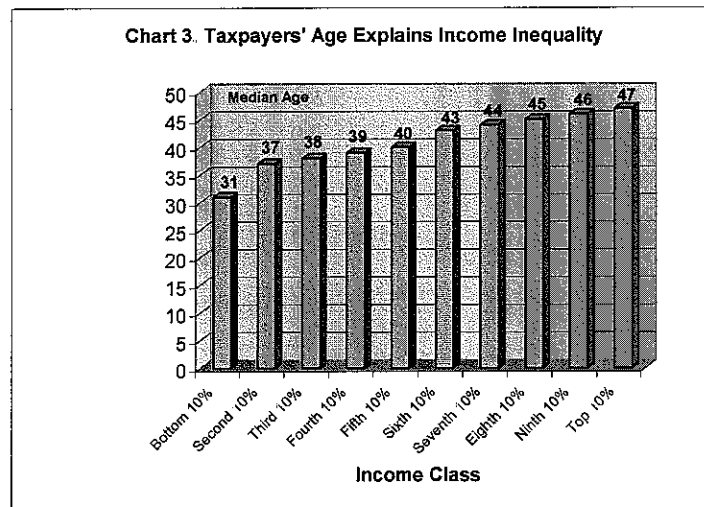
Source: Tax Foundation Matched IRS/Census Database

This illustrates an ironic result of our progressive tax rate system and our national efforts to encourage young students to get a college education – there is a stiff tax penalty for higher education. While high marginal tax rates may not necessarily dissuade a student from seeking a college degree, those rates could undermine the ability of U.S. companies to attract skilled workers from abroad and provide another incentive for companies to outsource skilled positions.

LIFE CYCLE AND INCOME “INEQUALITY”

One of the more overlooked explanations for the difference in incomes between taxpayers is the issue of life cycle. Most Americans understand the concept of life cycle, having watched our parents and grandparents work and retire.

Tax Foundation economists used our matched IRS/Census database to calculate the median age of taxpayers within each income group. Chart 3 shows that the lowest-income taxpayers (those in the bottom 10 percent) have a median age of 31 years. Looking at the



remaining income groups reveals the progression of taxpayers' incomes as they age in the workforce. Taxpayers in the middle 10 percent group have a median age of 40, while those in the wealthiest 10 percent have a median age of 47. These findings also have very important policy implications. Cutting the highest marginal tax rates will disproportionately benefit older taxpayers who are preparing for retirement, providing them more disposable income to save in their retirement plans.

THE WEALTHY CLASS IS ALSO OUR ENTREPRENEURIAL CLASS

Over the past 25 years, the number of individual taxpayers reporting business activity on their tax returns has grown at a rapid rate. Between 1980 and 2002, for example, the total number of sole proprietorships, partnerships, farms, and S-Corporations nearly doubled, from 13.3 million in 1980 to 25.5 million in 2002. S-Corps alone grew 500 percent, from 545,389 in 1980, to roughly 3.2 million in 2002, and now far exceed the number of conventional C-Corporations.

When we look carefully at the distribution of these tax returns a clear picture emerges: as taxpayers' incomes rise, so too does the likelihood that they have some form of business income (schedule C, E or F) reported on their tax return. Overall, 43 percent of taxpayers in the top 20 percent have business income – twice the percentage of those in the middle-income group. Of those taxpayers in the wealthiest 1 percent – those earning more than \$300,000 and subject to the highest marginal tax rates – nearly three quarters have business income. And for taxpayers with incomes above \$1 million per year, nearly 83 percent have business income.

Remarkably, because so many taxpayers have business income (or are paying business's taxes through individual tax forms), Tax Foundation economists estimate that individual taxpayers with business income paid 54.3 percent of all individual income taxes in 2004³.

CONCLUSION AND POLICY RECOMMENDATION

Tax policy should only be a means of raising sufficient funds for the government. It should not be a tool for social policy – either to punish one group of taxpayers or enrich another group. Yet it is clear that this nation's attempts to use progressive tax rates to make the wealthy pay more, while using targeted tax measures to reduce the burden on the middle class, has created two Americas – the “payers” and the “non-payers.”

³ Hodge and Moody, <http://www.taxfoundation.org/sr131.pdf>

The only way to mitigate the punishing effects of our current progressive rate structure on dual-income couples, older workers, the college educated, business owners, and families living in high-cost communities, is to enact a single-rate tax levied on consumption or on incomes. Such a tax should be set at a low rate, applied to a broad base, and have as few deductions as is politically possible.

Despite polls indicating that Americans would prefer that every taxpayer pay at least something toward the cost of government, many lawmakers will undoubtedly balk at the prospect of bringing at least 44 million Americans back on the income tax rolls.

One solution is to provide a generous family allowance – say, a zero tax rate on the first \$40,000 of income for a family of four – then apply the single-rate tax to every dollar above that pre-determined level. A single-rate tax on income or consumption (income minus savings) that included a family allowance would likely produce the same progressivity of the current system without the maddening complexity that frustrates Americans of all income levels.

Single-rate systems have become widespread among Central and Eastern European countries, including: Georgia, Estonia, Latvia, Lithuania, Romania, Russia, Serbia, Slovakia and Ukraine⁴. While each is slightly different in its construction and base, they share the simplicity of compliance and administration. Surely we could adapt a similar system to the United States.

Today's middle class is not our father's middle class, certainly not in most major metropolitan areas in America. The term "middle class" represents a value system, not just a point on the income scale. If "middle class" is defined as "working, married couples jointly raising children," the vast majority of today's middle class are in fact statistically rich – and are being punished by our progressive income tax system. The only way this panel can help them is by scrapping the old code and recommending a single-rate tax system.

⁴ *The Economist*, April 16, 2005