

Skin in the Game

The Federal Tax System and Poor Families

By Michael Evans

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Marguerite Casey Foundation exists to help low-income families strengthen their voice and mobilize their communities in order to achieve a more just and equitable society for all. In furtherance of this mission, the Foundation commissioned this non-partisan analysis regarding the federal tax system and poor families. The Foundation is pleased to make this paper available to the public, including to its grantees and others with an interest in this issue. Please note, however, that this paper is not intended to be used in connection with any activity that would constitute direct or grassroots lobbying within the meaning of the Internal Revenue Code (including, but not limited to, distribution of this paper in connection with communications that directly encourage the recipients to take action with respect to any of the legislation discussed in this paper).

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EXECUTIVE SUMMARY

In recent years, it has been argued that the federal income tax system is flawed because a significant percentage of people do not have “skin in the game,” that is, they do not pay federal income taxes. It is true that a significant percentage of Americans do not pay federal income taxes, and that the percentage rose sharply, to slightly more than 50 percent, in 2008 and 2009 (but has fallen since). However, this does not necessarily reflect a flaw in the income tax system; instead, it can be seen as reflecting economic conditions, fundamental principles embedded in the income tax system, and a series of policy choices designed to help poor families improve their economic circumstances.

As a threshold matter, it is important to recognize that the argument that a large percentage of Americans do not pay federal income taxes is based on the premise that only income taxes should be considered for this purpose and that, accordingly, payroll taxes do not count. However, this premise overlooks the growing role payroll taxes play in funding the federal government and the substantial contribution lower-income workers make in paying them.

Turning nevertheless to federal income taxes (that is, accepting, for purposes of the argument, that only income taxes are the relevant measure), an important principle of the federal income tax system has been that those earning less than a basic income threshold, such as the federal poverty level, should not be subject to any federal income tax. This principle was embodied in the early versions of the federal income tax, and it has been a permanent feature since. Indeed, during the debate over comprehensive tax reform in 1986, President Ronald

Reagan said, “[f]amilies with income at or below the poverty level should not be subject to income tax,” a position that Congress ratified. Today, this fundamental principle is reflected in the basic income tax thresholds, primarily through personal exemptions and the standard deduction.

The principle that those earning below a basic income threshold should not be subject to income tax has been complemented by the Earned Income Tax Credit (EITC), which was enacted in order to provide relief to poor working families who had suffered economic setbacks, to provide an incentive to work, to offset payroll taxes, and to provide an economic stimulus. Since 1975, the EITC has been enhanced several times by both Republican and Democratic administrations and Congresses. In addition to the basic income tax threshold and the EITC, Congress has enacted several other measures that reduce or eliminate taxes for some low-income people, including the child tax credit (CTC), the partial exclusion of Social Security benefits, and various temporary tax measures that have been established in recent years to promote economic recovery and assist those harmed most severely by the recession. In addition to these policy decisions, the rise in the percentage of Americans who do not pay income taxes has been driven by the recession and by the uneven rise in income levels over the past thirty years, as has been discussed in a recent Congressional Budget Office report.

Taking these factors into account, the issue becomes whether the fact that a significant percentage of Americans do not pay income taxes is a cause for concern. Those concerned with the status quo argue that the lack of “skin in the game” undermines civic responsibility, creates pressure for more government spending, and creates pressure for higher income taxes on upper-income taxpayers. However, these arguments are subjective and lack empirical support, and they must be weighed against the longstanding principle that those with low incomes should receive

income tax relief in recognition that they make other contributions and should devote their limited resources to caring for themselves and their families and to improving their economic circumstances. Finally, insofar as one concludes that the current distribution of the income tax system is cause for concern, the question then becomes: what could be done instead? Several policy options are presented, though each could arguably be said to suffer significant defects, such as decreasing the tax code's progressivity by increasing taxes on lower- and middle-income families and decreasing incentives to work.

“Skin in the Game”: The Federal Tax System and Poor Families

By Michael Evans¹

In recent years, the longstanding debate about the appropriate rate of progressivity of the income tax has been augmented by the argument that the federal income tax system is flawed because a significant percentage of people do not have “skin in the game,” in that they do not pay federal income taxes.² This report examines the argument. It begins by providing historical background about the federal income tax system as it relates to poor families and lower-income individuals. Then it discusses recent trends, focusing on the reasons why a significant percentage of Americans currently do not pay federal income taxes and on the public policy implications. Finally, it discusses possible changes to the income tax that could be made to alter the status quo and the implications such changes could have.

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² *Coats: Change Tax Code to Get More People Paying into System*, COURIER PRESS (July 23, 2011 at 7:24 p.m.), http://www.courierpress.com/news/2011/jul/23/no-headline---ev_taxes/ (last visited Sept. 26, 2011) (“I believe that everyone needs to have some skin in the game,” said [Senator Dan Coats (R-IN)].”). See also, 157 CONG. REC. S4412 (daily ed. July 7, 2011) (statement of Sen. John Cornyn) (“But right now, the fact [is] that according to the Committee on Joint Taxation, 51 percent – that is a majority of American households – paid no income tax in 2009. Zero. Zip. Nada. No income tax was paid by 51 percent of the households in America in 2009. Actually, to show how out of whack things have gotten, 30 percent of American households actually made money from the tax system by way of refundable tax credits, the earned income tax credit, among others.”); 157 CONG. REC. S4350 (daily ed. July 6, 2011) (statement of Sen. Orrin Hatch) (“I hear how they are so caring for the poor and so forth. The poor need jobs, and they also need to share some of the responsibility. We don’t want the very poor people who are in poverty to pay income taxes – but 51 percent of all households?”); *Everybody Should Pay Taxes*, WALL STREET JOURNAL (July 21, 2011), <http://blogs.wsj.com/washwire/2011/07/21/bachmann-everybody-should-pay-taxes/> (last visited Oct. 16, 2011) (“Ms. Bachmann turned the conversation elsewhere: ‘Part of the problem is today, only 53% pay any federal income tax at all; 47% pay nothing We need to broaden the base so that everybody pays something, even if it’s a dollar.’”); Harvey Gollub, Op-Ed., *My Response To Buffett And Obama*, WALL STREET JOURNAL (Aug. 22, 2011) (“Almost half of all filers pay no income taxes at all. Clearly they earn less and should pay less. But they should pay something and have a stake in our government spending their money too.”).

I. HISTORICAL BACKGROUND

Introduction

The federal income tax system always has been progressive, based on ability to pay. Although there is a longstanding and unsettled debate about the appropriate degree of progressivity (and how it should be measured), two fundamental concepts have been consistently maintained. The first is that people whose incomes fall below an appropriate threshold should not be taxed at all. The second is that, for people above that threshold, tax rates should be progressive, rising to some extent as income rises.³

The Early Years

From 1789 until the Civil War, and then again from 1872 to 1913, the federal government principally raised revenue from tariffs imposed on imports.⁴ When the need for large amounts of revenue during the Civil War prompted President Lincoln to propose and Congress to enact the Revenue Act of 1862, the income tax applied to incomes above \$600,

³ The federal income tax is progressive: that is, on average, the greater one's income, the greater the percentage of income paid in taxes. The degree of this progressivity, however, can be viewed from two perspectives, leading to different conclusions about whether the degree of progressivity has increased or decreased over time. From the first perspective, the emphasis is on the *amount of taxes paid*, expressed both in total dollars and as a percentage of total income taxes paid. In 2007 (the most recent year for which data is available from the Internal Revenue Service), the lowest fifth, or "quintile," of earners received a net tax benefit equal to 3 percent of all income taxes paid, while the top quintile paid 86 percent of all taxes paid. Further, the top quintile's share of federal income taxes paid has grown steadily in the last 30 years, while that of all other quintiles has declined. The second perspective on progressivity, in contrast, focuses on *effective tax rates* rather than on the share of income taxes paid, thereby also taking into consideration each income quintile's share of total income earned. The distinction between these two approaches is important because the top quintile's share of total income has increased steadily, rising from 45.5 percent in 1979 to 55.9 percent in 2007, while the effective tax rate paid by the top quintile fell from 15.7 percent to 14.4 percent. Thus, from this perspective, since the income of the highest earners has risen while their effective tax rate has fallen, the income tax appears somewhat less progressive than it does when considering only the percentage of taxes paid. From this perspective, the degree of progressivity has declined rather than risen over the past 30 years. See CONG. BUDGET OFFICE, SHARES OF FEDERAL TAX LIABILITIES FOR ALL HOUSEHOLDS, BY COMPREHENSIVE HOUSEHOLD INCOME QUINTILE, 1979-2007 (June 7, 2010), <http://www.cbo.gov/publications/collections/collections.cfm?collect=13> (last visited on Oct. 17, 2011).

⁴ LILLIAN DORIS, THE AMERICAN WAY IN TAXATION: INTERNAL REVENUE, 1862-1963 16-17 (1963).

which is roughly equivalent to about \$13,000 today, with graduated rates above that.⁵ In urging enactment, the Chairman of the House Ways and Means Committee, Thaddeus Stevens, praised the progressivity of the income tax, stating, “While the rich and the thrifty will be obliged to contribute largely from the abundance of their means . . . no burdens have been imposed on the industrious laborer and mechanic The food of the poor is untaxed; and no one will be affected by the provisions of this bill whose living depends solely on his manual labor.”⁶ When Congress re-established an income tax in 1913, following the ratification of the 16th Amendment, the tax applied to incomes above \$4,000 (joint return), which is equivalent to about \$90,000 today, with graduated rates above that. It required less than four percent of all Americans to pay income taxes.⁷

Over time, the federal government came to increasingly rely on the income tax as its primary source of revenue, with the principal shift coming during World War II. For the first time, the income tax became a “mass tax,”⁸ with the number of Americans paying income taxes

⁵ *Id.* at 19. The Civil War income tax exempted the first \$600 of income and imposed a 3 percent rate on incomes between \$600 and \$10,000, and a 5 percent rate on those over \$10,000. *Tax History Museum: 1861-1865: The Civil War*, TAX ANALYSTS, <http://www.taxhistory.org/www/website.nsf/Web/THM1861?OpenDocument> (last visited September 26, 2011). The tax expired in 1872, with the federal government again becoming dependent on tariffs for revenue.

⁶ CONG. GLOBE, 37TH CONG., 2ND SESS. 1576-77 (1862).

⁷ *Federal Income Tax of 1913*, MAJOR ACTS OF CONGRESS. Ed. Brian K. Landsberg. Macmillan-Thomson Gale, 2004 (26 Sept. 2011) <http://www.enotes.com/major-acts-congress/federal-income-tax>.

⁸ Doris, *supra* note 4, at 28. With respect to the personal exemption, which always has been a feature of the federal income tax, in the 1960s, with inflation having substantially eroded the value of the personal exemption of \$600 established in 1944, Congress made a series of changes to increase it, allowing it to reach \$1,000 by 1979. With respect to the standard deduction, in 1944 Congress established a standard deduction of 10% of adjusted gross income, with a ceiling of \$500 for single taxpayer and \$1,000 for a married couple filing jointly (roughly \$6,250 and \$12,500 in 2011 dollars). In 1964, Congress added a minimum standard deduction of \$200 plus \$100 for each exemption (roughly \$1,420 and \$710 in 2011 dollars), with a \$1,000 ceiling, allowing taxpayers who did not itemize to claim either the percentage standard deduction or the minimum standard deduction. Beginning in 1969, these standard deductions were increased substantially, with the percentage standard deduction gradually increased to 16%, the ceiling increased to \$2,000, and the minimum standard deduction (renamed the “low-income allowance”) increased to \$1,300. In 1975, the low-income allowance was differentiated based on family type (joint, head of household, single), with joint returns receiving a \$2,100 allowance, and the ceiling on the percentage standard deduction also was differentiated by family type and was raised to \$2,800 for joint returns by 1976. In 1977, the

rising from eight million before the war to 60 million after.⁹ As the income tax became a mass tax, Congress periodically modified the personal exemption and standard deduction, thereby adjusting the income thresholds at which people became subject to the income tax, in order to, as a 1964 House report said, “remove from the tax rolls those persons with minimum incomes.”¹⁰ For example, in 1970, with a standard deduction of \$1,000 and a personal exemption of \$750, a family of four was not subject to federal income tax on its first \$4,000 in income, which is equivalent to about \$22,500 today.

As a related matter, Congress has effectively chosen to exempt the majority of retirees from income tax. Currently, there are three principal tax benefits for senior citizens: (1) the exclusion of Social Security and railroad retirement benefits from gross income for filers whose income is below \$25,000 for individuals (\$32,000 for couples); (2) the additional standard deduction for the blind and elderly in 2011; and (3) the tax credit for the elderly and disabled. Indeed, the exclusion of Social Security benefits from taxation has been among the top ten largest tax expenditures almost every year since 1975, with an estimated cost of \$173 billion from 2010-2014.¹¹

low-income allowance and the percentage standard deduction were consolidated into a single flat allowance called the zero-bracket amount, which was set at \$3,200 for 1978. This zero-bracket amount was indexed in 1981, so that it would rise with inflation. The Tax Reform Act of 1986 raised the flat deduction amount, but continued to differentiate it with respect to family status (but not family size). The 2001 Act increased the standard deduction for joint returns to twice that of single returns.

⁹ *Id.*

¹⁰ H.R. REP. NO. 88-749, at 1333 (1964).

¹¹ STAFF OF J. COMM. ON TAXATION, 111th CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2010-2014 50 (JCS-3-10); STAFF OF J. COMM. ON TAXATION, 112th CONG., BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES 17 (JCX-15-11).

*1975: The Earned Income Tax Credit*¹²

The concept of a tax credit for the working poor emerged in the late 1960s during debates on poverty, on the one hand, and welfare dependency, on the other. In 1969, President Richard Nixon proposed to reform federal income support programs by establishing the “Family Assistance Plan” (FAP), which would provide a guaranteed cash income to all families as an alternative to existing public assistance programs. In proposing the plan, President Nixon said that the nation should “assure an income foundation throughout every section of America for all parents who cannot adequately support themselves and their children.”¹³

President Nixon’s effort to establish the FAP failed. Despite some initial support, it was sharply criticized, with some social welfare advocates arguing that the proposed benefits were too low and others, led by the Chairman of the Senate Finance Committee, Senator Russell B. Long (D-LA), arguing that the proposal would constitute, as Senator Long put it, “paying people not to work.”¹⁴ As it became clear that the proposal lacked sufficient congressional support, Senator Long developed an alternative proposal: a tax credit for low-income taxpayers who work, which he called a “work bonus” and which eventually became the Earned Income Tax Credit (EITC).

As enacted in the Tax Reduction Act of 1975, the EITC provided a refundable credit of 10 percent of the first \$4,000 of earned income, for a maximum credit of \$400, available to

¹² For a detailed discussion of the development of the Earned Income Tax Credit, see Marguerite Casey Foundation, *The Earned Income Tax Credit: Analysis and Proposals for Reform*, TAX NOTES, Dec. 26, 2005.

¹³ PRESIDENT RICHARD NIXON, SPECIAL MESSAGE TO THE CONGRESS ON REFORM OF THE NATION’S WELFARE SYSTEM (Aug. 11, 1969). The FAP would have provided an annual payment of \$1,600 a year for a family of four with an income of less than \$1,000.

¹⁴ Dennis J. Ventry Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit*, 53 NAT. TAX J. 983, 992 (2000).

taxpayers with at least one child.¹⁵ The Senate committee's report plainly stated the goals of the EITC:

This new refundable credit will provide relief to families who currently pay little or no income tax. These families have been hurt the most by rising food and energy costs. Also, in almost all cases, they are subject to the Social Security payroll tax on their earnings. Because it will increase their after-tax earnings, the new credit, in effect, provides an added bonus or incentive for low-income people to work, and therefore, should be of importance in inducing individuals with families receiving Federal assistance to support themselves. Moreover, the refundable credit is expected to be effective in stimulating the economy because the low-income people are expected to spend a large fraction of their increased disposable incomes.¹⁶

Thus, Congress justified the enactment of the EITC on the grounds it would increase earnings for poor families who had been hurt by rising energy and food costs, provide unemployed individuals with an incentive to work, offset the Social Security payroll tax, and provide a modest economic stimulus through poor families that were likely to spend the majority of their disposable income. Since 1975, Congress has reaffirmed its commitment to the central principles underlying the EITC time and time again, referencing the justifications given for its creation in 1975.¹⁷

¹⁵ Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975).

¹⁶ S. REP. NO. 94-36, at 11 (1975).

¹⁷ See, e.g. S. REP. NO. 99-313, at 43-44 (1986); H.R. REP. NO. 99-426, at 94-96 (1986); 139 CONG. REC. 11,635 (1993) (Rep. Dan Rostenkowski stating, in reference to the Omnibus Budget Reconciliation Act of 1993, “[u]nder this bill, through expansion and simplification of the earned income tax credit, no American family with a full-time worker need live below the poverty line”); 155 CONG. REC. S2,305 (daily ed. Feb. 13, 2009) (Senator Carl Levin stating, in reference to the American Recovery and Reinvestment Act, “[f]or many struggling families, these targeted tax cuts [referencing the expanded EITC and CTC, among other credits] will help them make ends meet in these tough times. Putting extra money in families’ pockets will offer an immediate boost to the economy”). See generally, Marguerite Casey Foundation, *supra* note 12.

Over the next ten years, the EITC was made permanent, the income threshold was raised, and various refinements were made to reflect the interaction between the EITC and federal welfare programs.¹⁸

The 1976 Act and the Child Care Tax Credit

Responding to concerns that the current-law itemized deduction for child care expenses was of limited benefit to lower-income workers, in 1976 Congress converted the deduction into a credit. “Treating child care expenses as itemized deductions denies any beneficial tax recognition of such expenses to taxpayers who elect the standard deduction. Your committee believes that such expenses should be viewed as a cost of earning income for which all working taxpayers may make a claim,” the House Ways and Means Committee explained in its Committee Report.¹⁹ The credit was equal to 20 percent of expenses, up to maximum expenses of \$2,000 for a single child or \$4,000 for two or more children, with a maximum credit of \$400 a year.²⁰

Since then, Congress has enacted a number of changes intended to better target the benefits of the credit to lower-income families, including increasing the credit’s rate from 20 percent of expenses and phasing out the credit for incomes above certain income thresholds.²¹ At the same time, Congress has allowed the maximum credit to decline relative to inflation.²² In

¹⁸ Marguerite Casey Foundation, *supra* note 12.

¹⁹ H.R. REP. NO. 94-658, at 147 (1976).

²⁰ Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

²¹ Child Care Credit, Tax Policy Center, <http://www.taxpolicycenter.org/taxtopics/encyclopedia/Child-care-credit.cfm> (last visited October 24, 2011).

²² Had the maximum credits established in the 1976 Act been allowed to grow with inflation, they would have been equal to roughly \$1,600 and \$3,200, respectively. However, given that the average child care tax credit claimed by all income groups is well below the maximum credit allowed, it is not clear that indexing the credit to inflation would have been a significant benefit to poor and middle-class families. For example, the average child care credit claimed by those with income of \$25,000 to \$40,000 was \$630 – the highest of any income group – in 2007. *Id.*

2011, the credit, now known as the Child and Dependent Care Tax Credit, is equal to 35 percent of expenses (up to maximum expenses of \$3,000 for one child and \$6,000 for two or more children) with a maximum credit, therefore, of \$1,050 and \$2,100, respectively.

The Tax Reform Act of 1986

The Tax Reform Act of 1986 established a historic consensus about many aspects of the income tax system, including the taxation of poor families. In his 1984 State of the Union Address, President Reagan challenged Congress to undertake a comprehensive reform of the tax code that would “simplify the entire tax Code, so all taxpayers, big and small, are treated more fairly.”²³ In his detailed tax reform proposal to Congress, President Reagan called for “fairness for the poor,” stating that “the tax system should not be an additional burden to those who are struggling to escape from poverty; insofar as possible, those below the poverty line should be freed from taxation altogether.”²⁴ To that end, President Reagan proposed increasing the standard deduction (zero-bracket amount), increasing the personal exemption, and increasing the EITC while indexing it to protect against inflation.²⁵ With specific regard to his proposed enhancements of the EITC, President Reagan’s proposal cited its importance in offsetting payroll taxes for low-income families and incentivizing them to work.²⁶

More broadly, President Reagan prioritized tax relief for low- and middle-income earners. His reforms to the individual income tax were guided, he said, by a desire to “increase

²³ PRESIDENT RONALD REAGAN, STATE OF THE UNION ADDRESS (Jan. 25, 1984).

²⁴ PRESIDENT RONALD REAGAN, THE PRESIDENT’S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY: SUMMARY 5 (MAY 1985).

²⁵ *Id.* at 4.

²⁶ PRESIDENT RONALD REAGAN, THE PRESIDENT’S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY: GENERAL EXPLANATION 17-18 (MAY 1985).

fairness for families.”²⁷ In an introductory discussion explaining the concepts underlying his reforms, the Reagan tax reform proposal stated:

*Families with income at or below the poverty level should not be subject to income tax. Thus, the level of income at which tax is first paid would be raised so that for most taxpayers it approximates the poverty level. This would be accomplished by raising the zero bracket amounts, relatively more in the case of heads of households, and doubling the personal exemption compared with its 1984 level. These proposed changes are designed to reflect differences in ability to pay taxes that result from differences in family size and composition. The working poor also would be protected by increasing the earned income credit and indexing it for inflation. (Emphasis added.)*²⁸

Congress ratified these basic principles in the Tax Reform Act of 1986, adopting President Reagan’s reforms for the taxation of individuals – the increase in the standard deduction and personal exemption, as well as the enhanced EITC – and in some cases providing even more generous tax relief.²⁹ The Senate Report states, “[t]ogether with the greatly expanded earned income credit, these provisions [the increased standardized deduction and personal exemption] *will relieve approximately six million low-income individuals from tax liability and will ensure that no families below the poverty level will have Federal income tax liability.*” (Emphasis added.)³⁰ The House Report states, “[t]he large increases in the standard deduction (formerly the zero-bracket amount), the personal exemption, and the expansion of the refundable earned income credit, under the committee bill, will raise the tax threshold and ensure that no

²⁷ *Id.* at 5.

²⁸ *Id.*

²⁹ Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). The 1986 Act provided more generous standard deductions and adopted Reagan’s proposed personal exemption of \$2,000 beginning in 1989. The Act also increased the rate of the EITC from 11 percent to 14 percent and indexed the credit to inflation.

³⁰ S. REP. 99-313 at 5 (1986).

families below the poverty level will have Federal income tax liability.”³¹ Indeed, the Senate Report notes that under the new rate structure, “more than 80 percent of individual taxpayers will either be in the 15-percent bracket or have no Federal income tax liability.”³²

President Reagan was proud of the significant tax relief the 1986 Act brought to poor and middle class families. In his remarks upon signing the 1986 Act into law, he praised it as “the best anti-poverty bill, the best profamily measure,” and noted that “[m]illions of working poor will be dropped from the tax rolls altogether, and families will get a long-overdue break with lower rates and an almost doubled personal exemption.”³³

Thus, in the Tax Reform Act of 1986, both President Reagan and Congress affirmatively ratified an income tax structure that exempted poor families from income taxes and maintained a strong EITC to ameliorate the impact of payroll taxes and create incentives to work.

Expansion of the EITC and Creation of the CTC

In 1990, as part of an omnibus budget bill, Congress increased the EITC and, for the first time, added a supplemental EITC for families with two or more children.³⁴ In 1993, President Clinton proposed legislation, enacted as the Omnibus Budget Reconciliation Act of 1993, which further expanded the EITC.³⁵ In his remarks advocating an expanded EITC, President Clinton stated, “This will be the first time in the history of our country when we’ll be able to say that if you work 40 hours a week and you have children in your home, you will be lifted out of poverty. It is an elemental, powerful, and profound principle. It is not liberal or conservative. It should

³¹ H.R. REP. 99-426 at 57 (1985).

³² S. REP. 99-313 at 36 (1986).

³³ PRESIDENT REAGAN, REMARKS ON SIGNING H.R. 3838 INTO LAW (October 22, 1986).

³⁴ Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

³⁵ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).

belong to no party. It ought to become part of the American creed.”³⁶ While the Omnibus Budget Reconciliation Act itself was controversial, primarily because of higher income taxes on upper-income taxpayers, the restructuring and expansion of the EITC do not appear to have generated any significant controversy, and the higher credit rates remain in place today.³⁷ Indeed, in his remarks on the Senate floor enumerating the reasons for his opposition to the bill, Senator Orrin Hatch’s (R-UT) criticism of the EITC provision was not that it was too generous, but rather that it retained the marriage penalty, so that married couples with children did not receive its full benefit.³⁸

In 1997, Congress provided additional tax relief to families by establishing a nonrefundable child tax credit (CTC) of \$500 for each of a taxpayer’s children, phased out above certain income levels.³⁹ It did so, the Congressional Joint Committee on Taxation explained, because:

The Congress believed that the individual income tax structure does not reduce tax liability by enough to reflect a family’s reduced ability to pay taxes as family size increases. In part, this is because over the last 50 years the value of the dependent personal exemption has declined in real terms by over one-third. The Congress believed that a tax credit for families with dependent children will reduce the individual income tax burden of those families, will better recognize the financial responsibilities of raising dependent children, and will promote family values.⁴⁰

³⁶ PRESIDENT BILL CLINTON, REMARKS ON THE ECONOMIC PROGRAM (July 31, 1993) (noting that 80 percent of the legislation’s new taxes are levied on individuals earning over \$200,000 a year, the top 1.2 percent of the income bracket).

³⁷ 139 CONG. REC. 14152-14162 (1993) (statement of Senator Orrin Hatch, listing his concerns with the legislation, but expressing regret that the EITC had not been modified to expand the credit for married couples).

³⁸ *Id.*

³⁹ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 778 (1997).

⁴⁰ STAFF OF J. COMM. ON TAXATION, 105th CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, (JCS-23-97).

The 2001 Tax Cuts

During his first year in office, President Bush proposed as the centerpiece of his economic agenda a comprehensive tax relief plan that cut taxes by \$1.5 trillion over ten years.⁴¹ Like President Reagan, President Bush highlighted his proposal's tax relief for lower-income taxpayers. His budget proposal to Congress states, "[t]he President's tax plan provides relief for every income taxpayer; however, it gives the lowest income families the greatest percentage reduction. Indeed, higher income individuals will pay a higher share of income taxes after this plan takes effect."⁴² Specifically, President Bush's proposed tax plan would have established a 10 percent bracket (to be phased-in by one percentage point every year, reaching 10 percent in 2006), provided marriage penalty relief, and increased the CTC from \$500 to \$1,000.⁴³

President Bush's proposal to Congress explained that tax relief for low wage earners was needed because of "an unfortunate quirk of the present tax Code that many low-income families are now facing higher marginal tax rates than wealthy individuals, due to the combined effect of the phase-out of the Earned Income Credit and the Income and Payroll Tax."⁴⁴ Indeed, in advocating his tax cut plan across the country, President Bush repeatedly emphasized that many households would no longer be subject to *any* income tax under his proposal. When he transmitted his tax plan to Congress, President Bush said, "[s]ix million families, one out of every five children, will no longer pay Federal income taxes at all under our plan."⁴⁵ Throughout his

⁴¹ U.S. DEPT. OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2002 TAX RELIEF PROPOSALS 59 (April 2001).

⁴² PRESIDENT GEORGE W. BUSH, A BLUEPRINT FOR NEW BEGINNINGS: A RESPONSIBLE BUDGET FOR AMERICA'S PRIORITIES 34 (2001).

⁴³ U.S. DEPT. OF TREASURY, *supra* note 41 at 1-5.

⁴⁴ BUSH, *supra* note 42.

⁴⁵ PRESIDENT GEORGE W. BUSH, REMARKS ON TRANSMITTING PROPOSED TAX CUT PLAN TO THE CONGRESS (February 8, 2001).

campaign for tax relief, President Bush told the story of a waitress with two children earning \$25,000 a year. Under his plan, President Bush explained that her income tax bill would be “wip[ed] out . . . entirely.”⁴⁶

As ultimately enacted, the Economic Growth and Tax Relief Reconciliation Act of 2001 was somewhat more progressive than the initial tax relief proposal put forth by President Bush, because congressional negotiations resulted in additional tax relief for low- and middle-income families.⁴⁷ In his remarks upon the bill’s passage, Senator Judd Gregg (R-NH) commented:

[f]or people who don’t even pay taxes today but have families and have issues with raising their children, they are going to receive a direct payment. Not an income tax refund, because they are not paying income taxes, but a direct payment to assist them in raising their children. This is a bill which is directed at the middle-class Americans – Americans who are working hard every day to make ends meet, some of them in a low enough tax bracket so they don’t pay taxes but still they need assistance.⁴⁸

2008 – Present

With the onset of recession in December 2007, President Bush, President Obama, and Congress focused on policies to avert recession and promote economic recovery, enacting a series of laws that contained, among other things, temporary tax relief. In 2008, Congress enacted the Economic Stimulus Act of 2008, which provided a one-time “recovery rebate,” in the form of a maximum refundable credit of \$600 for single filers (\$1,200 for married joint filers)

⁴⁶ PRESIDENT GEORGE W. BUSH, THE PRESIDENT’S RADIO ADDRESS (February 3, 2001).

⁴⁷ For example, President Bush’s proposal to Congress would have doubled the CTC from \$500 to \$1,000 per child, but the EGTRRA itself went one step further by making the credit partially refundable. As provided for in EGTRRA, if the value of the CTC exceeded a family’s tax liability, then the family could claim a refund equal to 10 percent (15 percent beginning in 2005) of earnings that exceeded \$10,000. STAFF OF J. COMM. ON TAXATION, 107TH CONG., SUMMARY OF PROVISIONS CONTAINED IN THE CONFERENCE AGREEMENT FOR H.R. 1836, THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 3-4 (JCX-50-01).

⁴⁸ 147 CONG. REC. S5,771 (daily ed. May 26, 2001) (statement of Senator Judd Gregg).

plus \$300 for each qualifying child.⁴⁹ Later that year, Congress also enhanced the CTC, lowering the refundable threshold for the credit from \$11,750 to \$8,500.⁵⁰ Together, these provisions provided \$3.25 billion in temporary tax relief.⁵¹

In 2009, Congress enacted the American Recovery and Reinvestment Act of 2009 (ARRA), which included a host of tax provisions providing further tax relief, including:⁵²

- **Making Work Pay Credit.** The bill created a credit equal to 6.2 percent of earned income up to a maximum credit of \$400 for single filers (\$800 for joint filers) for 2009 and 2010. The credit cut taxes for more than 95 percent of working families.
- **EITC.** The bill increased and expanded the EITC for families with three or more children by temporarily increasing the EITC from 40 percent to 45 percent of the family's first \$12,570 income earned. The bill also increased the phase-out threshold for married couples filing joint returns by \$5,000.
- **CTC.** The bill temporarily reduced the earnings threshold for the refundable portion of the child tax credit for 2009 and 2010 to \$3,000 (down from \$8,500 in 2008).
- **Exclusion of Unemployment Insurance Benefits.** The bill excluded up to \$2,400 of unemployment insurance benefits from gross income for 2009.
- **Recovery Payments.** The bill provided a one-time payment of \$250 to retirees, disabled individuals, and Social Security insurance recipients. Any payment received reduced the Making Work Pay Credit that would otherwise have been received by the taxpayer.

Most recently, at the end of 2010, Congress extended the 2001 tax cuts through 2012. It also extended some, but not all, of the 2009 economic stimulus provisions, extending the enhanced EITC and CTC benefits, but allowing the Making Work Pay Credit, the exclusion of a

⁴⁹ Economic Stimulus Act of 2008, Pub. L. No. 110-185, §101, 122 Stat. 613 (2008).

⁵⁰ Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §30, 122 Stat. 3765 (2008). Prior to the law, the refundable portion of the child tax credit was equal to 15 percent of earned income in excess of \$11,750. EESA lowered this threshold to \$8,500.

⁵¹ STAFF OF J. COMM. ON TAXATION 110TH CONG., ESTIMATED BUDGET EFFECTS OF THE "ECONOMIC STIMULUS ACT OF 2008" at 1 (JCX-17-08); STAFF OF J. COMM. ON TAXATION, 110TH CONG., ESTIMATED BUDGET EFFECTS OF THE TAX PROVISIONS CONTAINED IN AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 1424 at 9 (JCX-78-08).

⁵² STAFF OF H. COMM. ON WAYS AND MEANS AND S. COMM. ON FINANCE, 111TH CONG., AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009: FULL SUMMARY OF SENATE FINANCE, HOUSE WAYS AND MEANS COMMITTEES 1-2 (Feb. 12, 2009).

portion of unemployment insurance benefits from income, and the one-time recovery payments to expire, partially replacing them with a one-year payroll tax reduction of two percentage points.⁵³

Pulling all of this together, tax policy since 2007 has generally tried to stimulate economic recovery. As such, the various tax cuts enacted have been temporary and simple to implement, primarily targeting low- and middle-income people who are more likely to spend the tax cuts and thereby stimulate demand. The design of these income and payroll tax cuts was not accidental. At the very beginning of the recession, during a 2008 Senate Finance Committee hearing exploring possible economic stimulus proposals, the Director of the Congressional Budget Office, Dr. Peter Orszag, testified that the key to generating short-term growth was increasing aggregate demand. He noted that, to do so, “on the tax side ... the key is to get money quickly to people who will spend most of it,” and that “[t]o boost cost-effectiveness further, policymakers would need to focus on lower-income households and those with difficulty borrowing.”⁵⁴ The Chairman of the Finance Committee, Senator Max Baucus (D-MT), asked Orszag whether the stimulus proposal that President Bush was then considering proposing, which would have eliminated the lowest tax bracket, could be made more cost-effective by providing, instead, a flat tax rebate to all taxpayers, with an additional “bonus” for each child. Orszag replied that Senator Baucus’ alternative would “likely have a higher cost effectiveness in terms of the budgetary effect,” because “[f]or any given pot of money, the more you target lower-income and credit-constrained households, the bigger the bang you get for your buck.”⁵⁵

⁵³ STAFF OF J. COMM. ON TAXATION, 111TH CONG., ESTIMATED BUDGET EFFECTS OF THE “TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010” 4 (JCX-54-10).

⁵⁴ *Strengthening America’s Economy: Stimulus that Makes Sense, Hearing before the S. Comm. on Finance*, 110th Cong. 6 (2008) (statement of Dr. Peter Orszag, Director, Congressional Budget Office).

⁵⁵ *Id.* at 9.

Ultimately, Congress enacted a stimulus measure – the “recovery rebate” – in the Economic Stimulus Act of 2008, which was modeled along the lines of Senator Baucus’ broad rebate to all taxpayers, rather on the approach initially considered by President Bush. Nevertheless, when he signed the 2008 economic stimulus into law, President Bush praised its “individual tax relief in the form of tax rebates [Which] will amount to as much as \$600 for individuals and \$1,200 for married couples, with additional rebates for families with children.”⁵⁶ Thus, the various economic stimulus laws, designed to be temporary and to stimulate demand, had the effect of providing some additional tax cuts to poor families, in some cases eliminating all income tax liability and providing tax rebates.

Summary

In light of the above, the history of the federal income tax system reflects three main developments with respect to the income tax and poor families.

First, ever since there has been a federal income tax, there has been widespread support for the proposition, reflected explicitly during the consideration of the Tax Reform Act of 1986 and reaffirmed since then (such as by President Bush during the debate about the 2001 tax bill), that those earning below the poverty level should not be subject to federal income taxes. Also, there has been a consensus that Social Security income should be taxed less than other income.

Second, since 1975, there also has been widespread support for the proposition, reflected in the enactment of the EITC and the subsequent bipartisan support for expansions of the EITC, that further tax relief is appropriate for lower-income working people, particularly in order to

⁵⁶ PRESIDENT GEORGE W. BUSH, STATEMENT ON SIGNING THE ECONOMIC STIMULUS INTO LAW (Feb. 13, 2008).

reduce the cost of payroll taxes, provide an incentive to work, and provide a modest economic stimulus.

Third, during the recent recession, Congress enacted a series of temporary tax relief provisions, designed to provide economic stimulus, which have provided modest tax cuts to virtually all families, including poor families.

The Basic Operation of the Current System

Before turning from the historical perspective to an analysis of why a significant percentage of Americans do not currently owe federal income taxes and the public policy implications of this circumstance, it may be useful to briefly review the basic operation of the current system as it stands in 2011.

The federal individual income tax is imposed on gross income, minus deductions and exclusions, with personal exemptions to reflect family size.⁵⁷ Once gross income has been established, individuals may claim credits, such as the EITC or CTC, to further reduce their income tax liability; in some cases these credits are refundable, i.e., they result in a cash payment from the government beyond any income tax owed.

A standard deduction may be used in lieu of itemized deductions. In 2011, the standard deduction was \$5,800 for unmarried taxpayers or married taxpayers filing separately, \$11,600 for married taxpayers filing jointly, and \$8,500 for taxpayers filing as head of household. A personal exemption of \$3,700 is allowed for each person filing the return and each dependent.⁵⁸

⁵⁷ Special tax rates lower than those which apply to regular income may apply to dividends and long-held capital gains.

⁵⁸ An additional standard deduction is allowed for blind taxpayers and taxpayers age 65 or older which is equal for 2011 to \$1,150 for married individuals and \$1,450 if the taxpayer is filing as single or head of household.

The EITC is a refundable tax credit that varies in size depending on income and family status. In 2011, the credit applies at four different rates, with a low rate (7.65 percent) for workers with no children, a much higher rate (34 percent) for workers with one child, an even higher rate for workers with two children (40 percent), and the most generous rate of 45 percent for workers with three or more children.⁵⁹ Once a worker's income reaches a certain level (\$16,690 for a single parent with one child), the credit reaches a peak and begins to phase out.⁶⁰ Parents may also claim a CTC (equal to \$1,000 in 2011) for each dependent child, with the aggregate CTC amount phased out for individuals with income over certain thresholds. If the CTC exceeds the taxpayer's tax liability, then a portion may be refundable, depending on the taxpayer's income. That portion equals 15 percent of earned income above \$3,000 for 2011. There also is a non-refundable tax credit for child and dependent care expenses, which is capped based on the number of children, up to a maximum credit of \$1,050 if there is one qualifying individual and \$2,100 if there are two or more qualifying individuals. The value of the child and dependent care tax credit phases out at income levels above a certain level.

Consider, for example, the income tax owed by a married couple with two children who earned \$80,000 in 2010 and claimed \$17,400 in itemized deductions for home mortgage interest and property taxes. They would have had personal exemptions of \$14,600, resulting in taxable income of \$48,000 and a tentative tax liability of \$6,366. Their CTC, child care credit, and Making Work Pay credit would have been \$2,000, \$1,200, and \$400, respectively, reducing their tax liability to \$2,766. They would not have been eligible for an EITC.

⁵⁹ CHRISTINE SCOTT, CONG. RESEARCH SERV., RS21352, THE EARNED INCOME TAX CREDIT (EITC): CHANGES FOR 2010 AND 2011 2 (2011).

⁶⁰ *Id.*

Or consider a single mother with two children who earned \$40,000 and claimed a standard deduction of \$8,400. She would have had personal exemptions of \$10,950, resulting in taxable income of \$20,650 and a tentative tax liability of \$2,504. Her CTC, child care credit, Making Work Pay credit, and EITC would have been \$2,000, \$1,320, \$400, and \$71, respectively. As a result, her income tax liability would have been eliminated and she would have received a net benefit of \$1,287, effectively offsetting 42 percent of her \$3,060 in payroll tax. See the Appendix for additional examples.

II. ANALYSIS

Trends

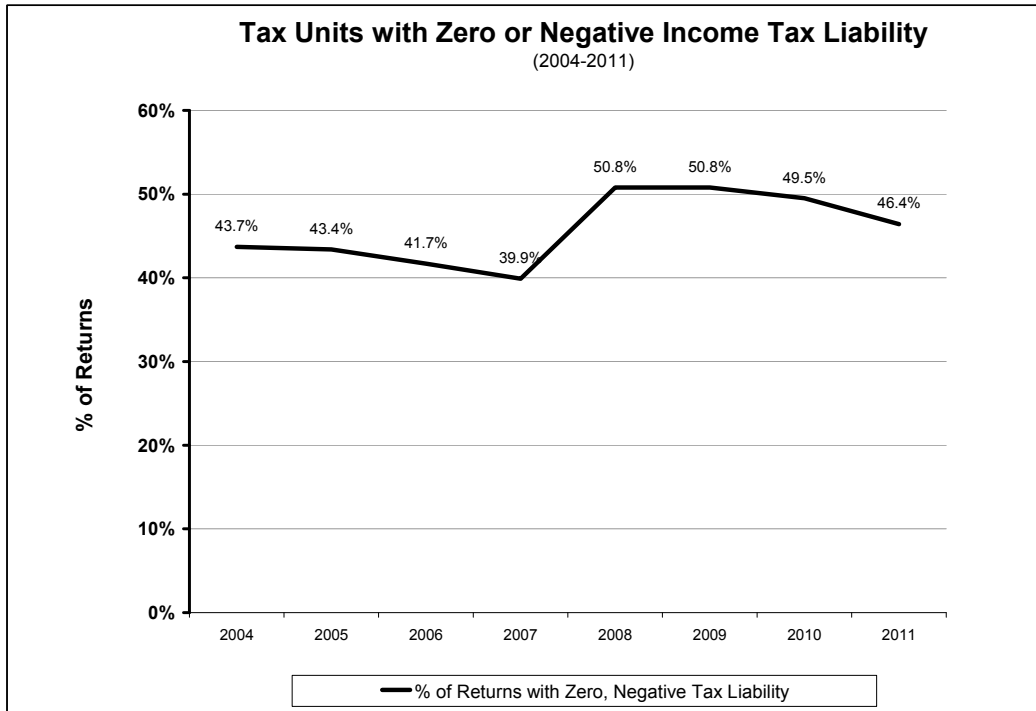
Over the last 25 years, the percentage of Americans owing no federal income taxes has risen. In 1986, 18.5 percent of tax returns had no income tax liability. For the next 22 years, the percentage of such returns increased at an average rate of 3.1 percent each year,⁶¹ reaching 42 percent by 2009,⁶² the last year for which Internal Revenue Service data is available. An alternative estimate of tax “units” with zero or negative income tax liability shows the same trend – though at higher percentage levels. According to these estimates, the percentage of tax units with zero or negative income tax liability was 39.9 percent in 2007, then rose sharply to 50.8 percent in 2008 and 2009.⁶³ The percentage of tax units with zero or negative income tax

⁶¹ SCOTT A. HODGE, TAX FOUNDATION, RECORD NUMBER OF PEOPLE PAYING NO INCOME TAX (Mar. 10, 2010), <http://www.taxfoundation.org/news/show/25962.html> (last visited Sept. 27, 2011).

⁶² Interview with Scott A. Hodge, President, Tax Foundation, in Wash., D.C. (Oct. 18, 2011).

⁶³ TAX POLICY CENTER, TAX UNITS WITH ZERO OR NEGATIVE TAX LIABILITY, 2004-2011 (June 14, 2011), <http://www.taxpolicycenter.org/numbers/content/pdf/T09-0333.pdf> (last visited Oct. 18, 2011).

liability now appears to be declining, to an estimated 49.5 percent in 2010 and 46.4 percent in 2011.⁶⁴



Source: TAX POLICY CENTER, TAX UNITS WITH ZERO OR NEGATIVE TAX LIABILITY, 2004-2011 (June 14, 2011), <http://www.taxpolicycenter.org/numbers/content/pdf/T09-0333.pdf> (last visited Oct. 18, 2011).

A number of lawmakers and policy experts have cited these figures to express concern that too few Americans are paying for the basic cost of government. This past August, Texas Governor Rick Perry said, “We’re dismayed at the injustice that nearly half of all Americans don’t even pay any income tax.”⁶⁵ At a Senate Finance Committee hearing in May on income tax distribution, Senator Hatch said, “I think many taxpayers are skeptical that the answer to our

⁶⁴ *Id.*

⁶⁵ TEXT OF GOV. RICK PERRY’S PRESIDENTIAL ANNOUNCEMENT REMARKS (Aug. 13, 2011).

current fiscal problem is for them to sacrifice more when almost half of all households are not paying any income taxes.”⁶⁶ There are many other examples.⁶⁷

The Payroll Tax/State Tax Issue

Given the recent emphasis on the number of Americans without federal income tax liability, it is appropriate to also consider their overall tax contribution to society.

As a threshold matter, the statement that a majority or close to a majority of Americans do not pay federal income taxes is based on the premise that, for purposes of assessing one’s “skin in the game,” payroll taxes don’t count. In other words, according to this premise, people who pay significant payroll taxes but do not pay income taxes should be treated as making no meaningful contribution to the funding of our government.

The adoption of this premise has a dramatic effect. In 2009, only 17.4 percent of households paid neither federal income tax nor payroll tax.⁶⁸ In other words, if federal payroll taxes are taken into account, the percentage of Americans who did not pay taxes in 2009 falls from 51 percent to 17 percent.

Further, the appropriateness of adopting the premise is not self-evident. It is true that income taxes and payroll taxes perform different functions, with income taxes funding the cost of general government and payroll taxes specifically earmarked for Social Security, Medicare, and unemployment insurance, which are programs of specific benefit to the taxpayer and the tax payments for which are in some respects similar to insurance premiums or deposits into a

⁶⁶ *Is the Distribution of Tax Burdens and Tax Benefits Equitable?: Hearing before the S. Comm. on Finance*, 112th Cong. (2011) (statement of Sen. Orrin Hatch).

⁶⁷ See note 2.

⁶⁸ TAX POLICY CENTER, *supra* note 63.

retirement account. However, it is not clear that these differences justify ignoring payroll tax payments in considering the taxes that Americans pay to their government.

For example, unlike insurance premiums and retirement savings, which individuals pay now in exchange for a contractual guarantee to receive a certain amount in the future, the taxpayer has no contractual guarantee from the government for future Social Security or Medicare benefits. In fact, one of the most important issues being debated today is whether and to what extent the federal government may have to modify these programs in order to reduce the federal debt.

Further, the federal government does not restrict its use of Social Security taxes to pay for Social Security benefits. The Secretary of the Treasury, as the Managing Trustee of the Social Security trust funds, is required by law to invest Social Security revenues in interest-bearing federal government securities held by the trust funds.⁶⁹ In exchange for the government securities, the Treasury Secretary deposits Social Security revenues into the general fund of the U.S Treasury. Once deposited, the Social Security revenues are indistinguishable from other revenue sources in the general fund and are used to pay for the general cost of government.⁷⁰ Thus, while nominally surplus Social Security taxes are placed in a trust fund to finance Social Security benefits, in fact these funds are immediately mixed with general revenues to fund other government programs.

Also, it is common to include both income taxes and payroll taxes in considering citizens' contributions toward funding the federal government. The Tax Foundation, for example, includes payroll taxes, excise taxes, and all other federal revenues in calculating the

⁶⁹ DAWN NUSCHLER, CONG. RESEARCH SERV., R42035, SOCIAL SECURITY PRIMER 3 (2011).

⁷⁰ *Id.* The Social Security trust fund balance represents the amount of money owed to the trust fund from the general fund of the U.S. Treasury.

“average tax burden” as part of its annual “Tax Freedom Day” calculation.⁷¹ In describing the tax burden of average Americans, the Tax Foundation places income and payroll taxes on equal footing, stating, “[t]he largest and most visible of these taxes are directly subtracted from Americans’ paychecks – individual income taxes and payroll taxes.”⁷²

Indeed, federal taxes other than income taxes are not insubstantial. Taking into account all federal taxes, the lowest-income 20 percent (or “quintile”) had a federal effective tax rate of four percent in 2007.⁷³ The second lowest income group paid 10.6 percent.⁷⁴

Further, in order to have a complete view of a person’s total tax contribution one must also consider state and local taxes, which generally are regressive,⁷⁵ resulting in a cumulative effect of U.S. federal, state and local taxes that is significantly less progressive than the federal tax system standing alone. Taking all federal, state and local taxes into account, in 2007 the lowest quintile paid an effective tax rate of 14.9 percent on its income, the second lowest quintile 20.6 percent, the middle quintile 24 percent,⁷⁶ the fourth quintile 26.7 percent, and the top quintile 33.6 percent.⁷⁷

Pulling all of this together, Americans below the poverty line have, on average, an effective tax rate, net of all federal, state and local taxes, of nearly 15 percent. Consequently, although they may not have any federal income tax liability, they do contribute tax revenue to

⁷¹ TAX FOUNDATION, <http://www.taxfoundation.org/taxfreedomday/> (last visited on Sept. 19, 2011).

⁷² TAX FOUNDATION, SPECIAL REPORT 5 (March 2011).

⁷³ CONG. BUDGET OFFICE, SHARES OF FEDERAL TAX LIABILITIES FOR ALL HOUSEHOLDS, BY COMPREHENSIVE HOUSEHOLD INCOME QUINTILE, 1979-2007 (June 7, 2010).

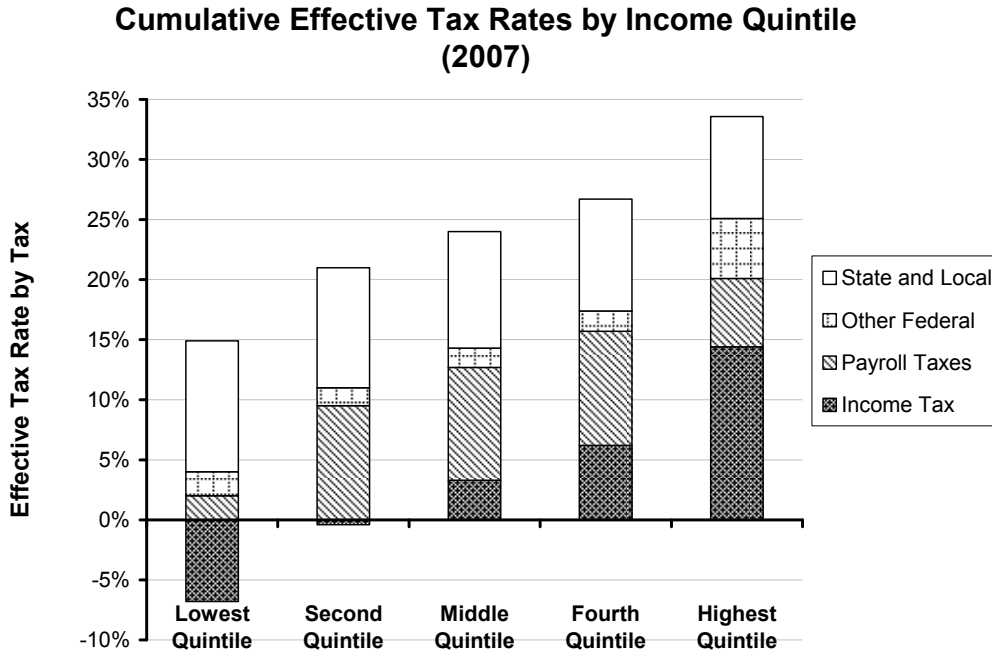
⁷⁴ *Id.*

⁷⁵ CARL DAVIS, KELLY DAVIS, ET AL., WHO PAYS? A DISTRIBUTIONAL ANALYSIS OF THE TAX SYSTEMS IN ALL 50 STATES, 118 (Nov. 2009). State and local effective tax rates, from bottom to top quintiles, equal 10.9 percent, 10 percent, 9.7 percent, 9.3 percent, and 8.8 percent or less for the top quintile.

⁷⁶ *Id.*, CONG. BUDGET OFFICE, *supra* note 73.

⁷⁷ *Id.*

support federal and state governmental institutions. The following graph depicts total state, local, and federal effective tax rates for all Americans.



Source: CONG. BUDGET OFFICE, SHARES OF FEDERAL TAX LIABILITIES FOR ALL HOUSEHOLDS, BY COMPREHENSIVE HOUSEHOLD INCOME QUINTILE, 1979-2007 (June 7, 2010); CARL DAVIS, KELLY DAVIS, ET AL., WHO PAYS? A DISTRIBUTIONAL ANALYSIS OF THE TAX SYSTEMS IN ALL 50 STATES, 118 (Nov. 2009).

Reasons for the Rising Number of Taxpayers without “Skin in the Game”

Assuming one accepts the premise that Americans only have “skin in the game” if they pay income taxes, the next step is to examine the reasons why people do not pay income taxes. While many factors have contributed to the generally rising proportion of people without income tax liability, two central reasons are economic conditions and the series of policy choices made over the last thirty years.

Recession and Economic Stagnation

One important reason for the growth in the percentage of people who do not pay income tax has been the recession. Before the recession, the percentage of people who didn't pay income taxes was actually modestly decreasing, but the recession abruptly reversed this trend.⁷⁸ Between 2007 and 2008, income fell for all income levels.⁷⁹ Income continued to fall between 2008 and 2009, dropping sharply, by 7.7 percent.⁸⁰ As the nation lost roughly one trillion dollars in income, the percentage of households not paying income tax jumped sharply, rising from 39.9 percent in 2007 to 50.8 percent in both 2008 and 2009.⁸¹

Another contributing factor, over the longer term, has been the growth in income inequality. During previous periods of post-World War II American economic history, real incomes have risen relatively evenly across household income levels.⁸² As a result, a greater percentage of families in the lower-income levels saw increases in their real income that took them above the poverty level and onto the income tax rolls. That has changed in the last several decades. While real income earned by those at the very top of the income scale has grown steadily, real income for those in the middle and at the bottom has remained flat.⁸³ From 1979 until 2007, the upper limit for real income for the lowest and second-lowest income quintiles

⁷⁸ TAX POLICY CENTER, *supra* note 63.

⁷⁹ I.R.S., STATISTICS OF INCOME – 2009 INDIVIDUAL INCOME TAX RETURNS (Rev. 07-2010) 1 (2010). In 2008, the Internal Revenue Service found that adjusted gross income (“AGI”) for all taxpayers decreased by \$424.9 billion, or 4.9 percent, from 2007 to 2008. Total tax liability decreased 6.2 percent. To put this substantial drop in perspective, between 2006 and 2007, AGI increased by 8.2 percent.

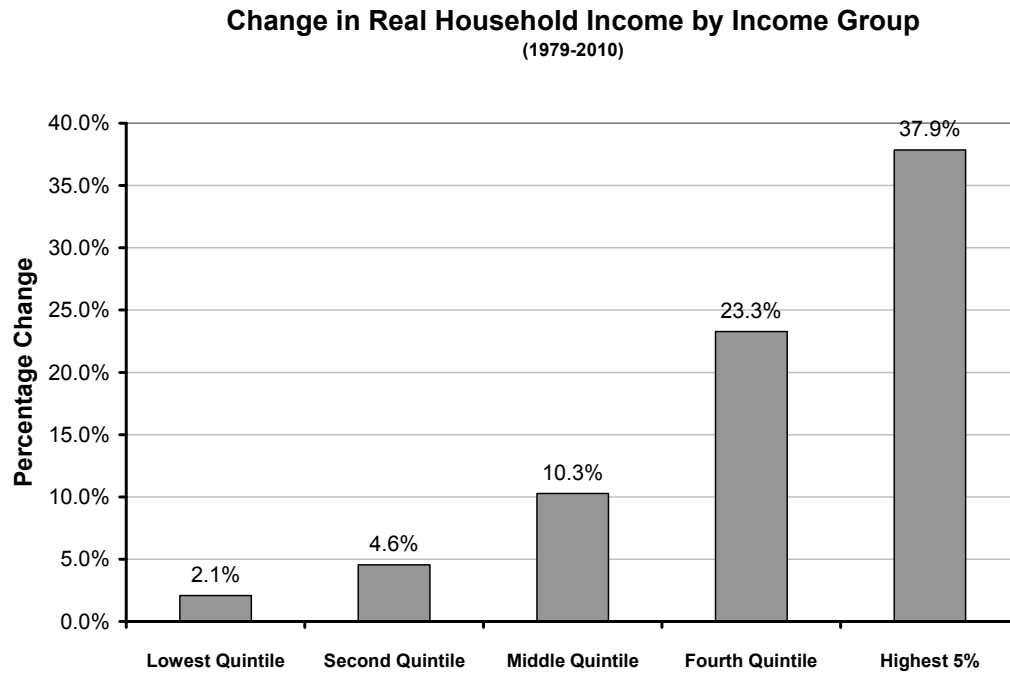
⁸⁰ *Id.*

⁸¹ TAX POLICY CENTER, *supra* note 63.

⁸² See When Income Grows, Who Gains? Economic Policy Institute (Jan. 2011), <http://www.stateofworkingamerica.org/pages/interactive#/?start=1981&end=2008> (last visited Oct. 18, 2011). Between 1945 and 1979, average real income grew by \$20,393. The wealthiest 10 percent received 34 percent of the benefit of this increase and the remaining 90 percent received 66 percent of the benefit.

⁸³ U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements (2011), <http://www.census.gov/hhes/www/income/data/historical/household/index.html> (last visited on Sept. 27, 2011).

rose by just 2.1 percent and 4.6 percent, respectively, while the lower limit for real income for the top five percent of income earners rose 37.9 percent.⁸⁴ The following graph illustrates this trend.



Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements (2011), <http://www.census.gov/hhes/www/income/data/historical/household/index.html> (last visited on Sept. 27, 2011).

Note: Real household income for purposes of this graph is defined as the upper limit of real household income for each income group, except in the case of the “Highest 5%” group, in which case real household income refers to the lower limit of income earned by the highest five percent of income earners.

Most recently, the Congressional Budget Office found that after-tax income, that is, income after federal taxes and transfers have been taken into account, for households at the higher end of the income scale has grown much more rapidly than income for poor and middle-class households. For example, the top one percent saw their average real after-tax household

⁸⁴ *Id.*

income grow by 275 percent between 1979 and 2007; in contrast, the bottom 20 percent saw their average real after-tax household income grow by 18 percent.⁸⁵

As a result, a growing number of families have remained at low income levels and have found their income tax liabilities reduced to zero because of lower marginal tax rates and tax credits, like the EITC and CTC, whose real value has increased over time. Further, the recent recession has exacerbated this long-term trend of income stagnation. During the height of the recession, real median household income fell by 3.2 percent between 2007 and 2009, and has continued to fall ever since.⁸⁶ Indeed, even as the economy has shown some more recent signs of recovery, real median household income fell an additional 6.7 percent between 2009 and 2011.⁸⁷ The continued decline in real household income has contributed to the rising number of Americans without income tax liability.

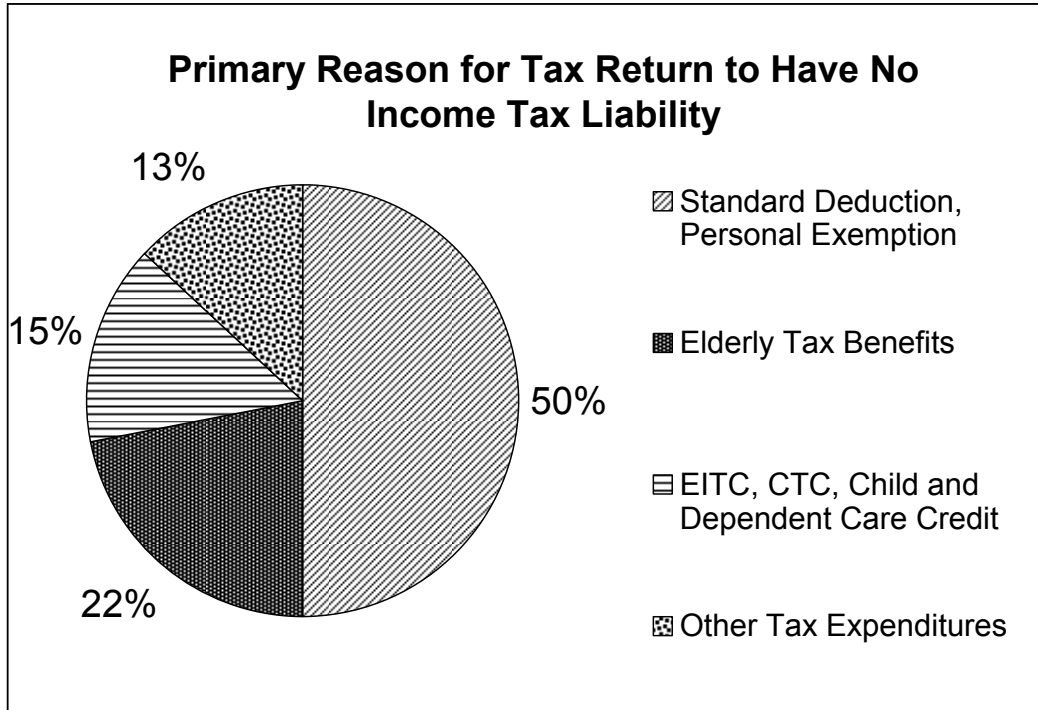
Policy Choices

From a policy perspective, the main reasons for the current income tax distribution, including the number of people with zero or negative income tax liability, are the affirmative policy choices made over the years. Specifically, as previously explained, Congress has chosen to exempt from the income tax entirely those at or near poverty, to exclude a significant portion of seniors' incomes from the income tax, to provide additional support to low-income workers through the EITC and to families with children through the CTC, and to provide temporary broad-based tax cuts as a form of economic stimulus.

⁸⁵ CONG. BUDGET OFFICE, TRENDS IN THE DISTRIBUTION OF HOUSEHOLD INCOME BETWEEN 1979 AND 2007 ix (2011). Transfer income includes cash payments from Social Security, unemployment insurance, Temporary Assistance for Needy Families, Medicare, Medicaid, and other various federal programs.

⁸⁶ Press Release, Sentier Research, Household Income Trends During the Recession and Economic Recovery 1 (Oct. 10, 2011).

⁸⁷ *Id.*



Source: RACHEL JOHNSON ET AL., TAX POLICY CENTER, WHY SOME TAX UNITS PAY NO INCOME TAX 2 (July 2011). Other tax expenditures include exclusions of other cash transfers, “above the line” deductions and tax-exempt interest, itemized deductions, education credits, other credits, and capital gains and dividends rates.

The impact of these policy choices can be seen by considering each in turn.

The historical consensus that those at or below the poverty line should not be subject to the income tax has resulted in the current level of the standard deduction and personal exemption, which exempt the poorest of society from the income tax. Of those expected to owe no income taxes in 2011, roughly 50 percent will have no income tax liability because of the standard deduction and personal exemptions.⁸⁸ Indeed, the sum of both provisions is roughly equivalent to the federal poverty level. For example, the poverty level for a single person for 2011 is \$10,890. A single unmarried worker with no children would pay no taxes on income up to \$9,500 due to the standard deduction and personal exemption. The poverty level for a four-person family is \$22,350. Assuming that family consists of a couple filing jointly, they would

⁸⁸ RACHEL JOHNSON ET AL., TAX POLICY CENTER, WHY SOME TAX UNITS PAY NO INCOME TAX 6 (July 2011).

pay no taxes on up to \$26,400 in income due to the standard deduction and personal exemptions. Analysis by the Congressional Research Service corroborates this, finding that nearly two-thirds of those with zero or negative liability on their income tax returns in 2009 were at or below 200 percent of the federal poverty threshold.⁸⁹

2011 HHS Poverty Guidelines	
Persons in Family	48 Contiguous States, D.C.
1	\$10,890
2	14,710
3	18,530
4	22,350
Each additional person add ...	3,820

Source: ANNUAL UPDATE OF THE HHS POVERTY GUIDELINES, 76 Fed. Reg. 3637, 3638 (Jan. 20, 2011).

With respect to senior citizens, as Americans get older they tend to retire or cut back on hours spent working, relying on savings and Social Security benefits, not wages, to finance their expenditures,⁹⁰ and Congress has exempted much of the income earned by seniors from the income tax.⁹¹ Twenty-two percent of those with no tax liability owe no income tax because of tax benefits for seniors.⁹²

⁸⁹ THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R41362, WHO DOESN'T PAY INCOME TAXES? 5 (2010).

⁹⁰ U.S. CENSUS BUREAU, 2007 AMERICAN COMMUNITY SURVEY (2011), http://factfinder.census.gov/servlet/DTable?_bm=y&-ds_name=ACS_2007_1YR_G00_&-CONTEXT=dt&-mt_name=ACS_2007_1YR_G2000_B19049&-redoLog=false&-geo_id=01000US&-format=&-lang=en&-SubjectID=17464778 (last visited Sept. 27, 2011). Median household income for 2008 was estimated to be \$50,740 for all ages, but was only \$32,158 for householders 64 years and older.

⁹¹ CHUCK MARR & BRIAN HIGHSMITH, CENTER ON BUDGET AND POLICY PRIORITIES, MISCONCEPTIONS AND REALITIES ABOUT WHO PAYS TAXES (May 31, 2011).

⁹² JOHNSON ET AL., *supra* note 88.

Finally, through the creation and expansion of the EITC and the CTC, Congress has decided over the years to cushion poor families from federal taxes. Of the 50 percent who have no income tax liability because of tax expenditures (i.e., those whose income exceeds the standard deduction and personal exemption amount), those without tax liability because of either the EITC or the CTC, or both, comprise 30 percent.⁹³ Congress established these credits in order to encourage individuals to seek work by offsetting the payroll tax and, in the process, to advance the broader societal goal of supporting families as they move up the income ladder. In this regard, the EITC and the CTC have been remarkably successful. In 2009 alone, both credits lifted 7.2 million people out of poverty, including four million children.⁹⁴

While there is some overlap of the beneficiaries of these credits, the EITC is principally a tax benefit for the working poor, whereas the CTC benefits both low- and middle-income families. For working families with two children, all of the benefits of the EITC go to families earning less than \$40,964 in 2011 (\$46,044 for couples).⁹⁵ Over 46 percent of recipients of the EITC refundable credit were below the poverty line in 2009. In contrast, roughly half of the CTC benefits go to taxpayers earning more than \$50,000.⁹⁶ A recent analysis by the Congressional Research Service states, “Among taxpayers with cash income above \$50,000, those with income between \$50,000 and \$75,000 receive the largest proportion of child tax credit benefits, 18.5%, underscoring the fact that this tax credit provides significant benefits to middle-

⁹³ *Id.* at 2.

⁹⁴ MARR & HIGHSMITH, *supra* note 91, at 9; ARLOC SHERMAN, CENTER ON BUDGET AND POLICY PRIORITIES, DESPITE DEEP RECESSION AND HIGH UNEMPLOYMENT, GOVERNMENT EFFORTS – INCLUDING THE RECOVERY ACT – PREVENTED POVERTY FROM RISING IN 2009, NEW CENSUS DATA SHOW 2 (2011). In 2009, the EITC and CTC kept 7.2 million people above the poverty line who otherwise would have fallen below.

⁹⁵ CHRISTINE SCOTT, CONG. RESEARCH SERV., RS21352, THE EARNED INCOME TAX CREDIT (EITC): CHANGES FOR 2010 AND 2011 2 (2011).

⁹⁶ *Id.*

income families. Most taxpayers with incomes above \$200,000 will be ineligible for the credit.”⁹⁷

As stated above, the EITC and CTC have had substantial antipoverty effects. Modifications to the credits over the years have made the credits more generous and also increased their efficacy by improving compliance.⁹⁸ In 2009, the EITC reduced poverty rates for families with children from 22.7 percent to 18.4 percent, approximately a one-fifth decrease.⁹⁹ Both the EITC and CTC lift a significant number of families out of poverty, with the EITC lifting 22 percent of its recipients out of poverty and the CTC lifting 14 percent.¹⁰⁰

Possible Reforms to the Federal Income Tax System

Congress could, of course, reconsider these policy choices. If Congress wished to increase the percentage of households paying federal income taxes, there would be several options to do so through changes to the income tax system. At the most fundamental level, Congress could change the basic structure of the income tax system by reconsidering the proposition that those earning below a threshold income level, such as the poverty level, should not pay income taxes and making the corresponding adjustments to the personal exemption and the standard deduction. Congress could also curtail other relevant income tax limitations, such as the EITC and CTC, by reducing the credit percentages, raising the refundability thresholds, or repealing both credits altogether. Further, Congress could reconsider the unique treatment of

⁹⁷ *Id.*

⁹⁸ A number of legislative changes have been made to improve EITC compliance, including requiring that dependents have identification numbers (Social Security numbers), prohibiting taxpayers from receiving the EITC from anywhere between two to 10 years after improperly or fraudulently receiving the credit, and imposing due diligence requirements on tax preparers. Additionally, the Working Families Tax Relief Act of 2004 established a more uniform definition of a child for purposes of the EITC, CTC, personal exemptions and other tax provisions. See CHRISTINE SCOTT, CONG. RESEARCH SERV., RL31768, THE EARNED INCOME TAX CREDIT (EITC): AN OVERVIEW 16-18 (2010).

⁹⁹ MARGARET L. CRANDALL-HOLLICK, CONG. RESEARCH SERV., R41999, THE IMPACT OF REFUNDABLE TAX CREDITS ON POVERTY RATES 11 (2011).

¹⁰⁰ *Id.* at 13.

seniors by adjusting the partial exclusion of Social Security benefits. Many other options are possible to expand the percentage of Americans contributing to the cost of funding general government, including the imposition of a national sales tax. Further, in designing future economic stimulus measures, Congress could refrain from simple and broad-based measures targeted at lower-income families – due to their greater stimulative effect – and instead make the policy choice to focus the relief on those paying income taxes.

Each option would have significant counter-effects. A decision to reconsider the fundamental proposition that those earning less than the poverty level should not pay income taxes would be historically unprecedented and regressive, and it likely would increase taxes on many middle-income taxpayers unless it were offset by other tax cuts, such as lower tax rates. Curtailing the EITC would reduce incentives to work and impose economic costs on low-income working families. Similarly, curtailing the CTC or the partial exclusion of Social Security benefits would raise taxes on many middle-class working families and seniors. Finally, a national sales tax would be sharply regressive.

In evaluating the advantages and disadvantages of maintaining the status quo versus adopting some or all of the options outlined above, further points should be considered. Foremost, several legislators and policy experts maintain that the increased percentage of households owing no federal income tax is a negative development that potentially harms our democracy and economy. Two principal arguments have been made in support of this viewpoint.

The first argument is that by exempting a significant portion of the population from paying income taxes, the current system undermines civic responsibility. Bearing the cost of government improves citizen stewardship, the argument goes, by giving citizens an incentive to

be better informed and less tolerant of wasteful or ineffective programs. As Tax Foundation President Scott Hodge testified at a recent Senate Finance Committee hearing, “It is an essential part of citizenship to be invested in this nation.”¹⁰¹ A closely related argument is that the current system creates a “fiscal illusion,” causing people who do not pay income taxes to underestimate the cost of government, thereby creating inappropriate pressure for more federal spending. Senator John Thune (R-SD) raised this concern in the Senate Finance Committee hearing, and Mr. Hodge responded, “I do think that when Americans feel or perceive that the government is cheaper, they’re going to demand more of it.”¹⁰²

There are several points in response to both of these arguments. First, the American economy features a degree of economic mobility, such that many people who do not pay income taxes today are likely to pay them tomorrow,¹⁰³ arguably giving them a significant stake in the operation of the government regardless of their tax liability in any particular year. Further, as a historical matter, the nation has not traditionally relied on a particular structure of the income tax system to promote citizenship. Indeed, for most of the nation’s history – up until World War II – the general population was not subject to federal income taxes and there is no evidence that American citizenship suffered as a result.

As for the “fiscal illusion” argument, at a time when so much of the federal budget is financed by deficit spending (i.e., paid for with borrowed money), the reality is that no American, even those paying income taxes, is fully internalizing the cost of the federal

¹⁰¹ *Is the Distribution of Tax Burdens and Tax Benefits Equitable?: Hearing before the S. Comm. on Finance*, 112th Cong. (2011) (statement of Scott A. Hodge, Tax Foundation).

¹⁰² *Id.*

¹⁰³ *Id.* “Our research has found that nearly 60 percent of households in the bottom income quintile move up to higher quintiles over at least a nine-year period of time. And those in the top often move down to the bottom or lower within a short period of time,” Mr. Hodge said at the hearing.

government. More to the point, with the federal government in 2011 borrowing nearly forty cents of every dollar it spends, it is hard to argue that only those not paying income taxes are discounting the cost of government.

Ultimately, the arguments for requiring more lower-income people to pay a greater share of federal income taxes are subjective. Further, these arguments must be weighed against the longstanding decision that society is better off if lower-income people devote their limited resources to caring for themselves and their families and to improving their economic circumstances.

Appendix

Examples of Tax Returns with Zero or Negative Tax Liability in Tax Year 2010						
	Student: Summer Job	Single Parent: Two Children	Single Parent: Two Children	Married Couple: Two Children	Senior Couple: Median Income	
Basic Provisions of the Code						
Income	\$3,600	\$20,000	\$40,000	\$50,000	\$10,000	
Social Security Benefits*					22,000 [†]	
Standard Deduction	5,700	8,400	8,400	11,400	13,600	
Exemption(s)	3,650	10,950	10,950	14,600	7,300	
Taxable Income	-5,750	650	20,650	24,000	-10,900	
Tentative Tax	0	66	2,504	2,766	0	
Nonrefundable Credits						
Dependent Care		1,920	1,320	1,200		
Child Credit		0	1,184	1,566		
Tentative Tax	0	0	0	0	0	
Refundable Credits						
EITC		4,283	71	0		
Additional Child Credit		850	816	464		
Making Work Pay Credit	223	400	400	400		
Tax	-\$223	-\$5,533	-\$1,287	-\$864	\$0	

* The exclusion of Social Security benefits and the additional standard deduction for seniors are generally considered to be tax expenditures and not basic provisions of the Internal Revenue Code. However, to simplify the chart, both have been incorporated into the "Basic Provisions of the Code" calculations.

[†] Because the couple's overall income in this example is below the Social Security income limit, all \$22,000 of Social Security benefits the couple received are excluded from income.