Tax Watch
Summer 2004

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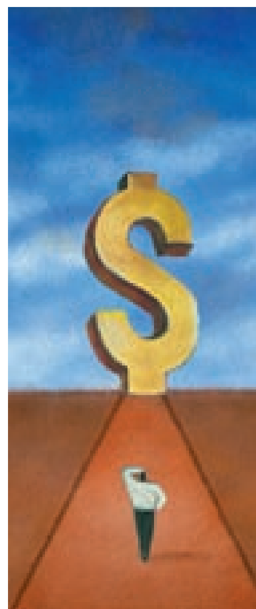
Making Sense of the Presidential Tax Plans

When voters head to the ballot box this November, one factor influencing their decisions will be the tax packages proposed by candidates.

That is, if they are able to comprehend them.

Presidential tax plans are notoriously complex, with political sound bites and tax jargon obscuring their impact. Given their complexity and vagueness, how should the average voter evaluate candidates' plans?

One way is to start with a few simple rules of "sound taxation," and then compare plans to these criteria. While this alone won't tell whether a tax plan is good or bad, it offers a simple, objective way to compare plans across candidates.



Over the years, economists from Adam Smith to Milton Friedman have offered their own lists of principles that should guide good tax policy. At the Tax Foundation, our economists have narrowed them down to five simple rules, which are applicable to a wide range of tax proposals. They are as follows:

1. Simplicity: The tax system should be as simple as possible. Complexity makes tax compliance needlessly expensive and punitive. Taxes should be easy to understand and comply with.

2. Transparency: A good tax system requires informed taxpayers. Tax plans should make it clear to the taxpayer who and what is being taxed, and for how much.

3. Stability and non-retroactivity: Tax law should not change continually. Good economic decisions require stable "rules of the game," and that includes predictable taxes. Taxpayers should be able to rely on the law as it exists when they enter into transactions, and not be penalized by subsequent tax changes.

4. Neutrality: The purpose of taxes is to raise revenue, not "socially engineer" the economy with subsidies and penalties. Taxes should aim to minimize economic distortion, favor broad tax bases and low rates, and should not attempt to micromanage economic outcomes.

5. Growth-promotion: Taxes should promote economic growth, and not interfere with trade or capital flows within the U.S. or across borders. Taxes should consume as small a portion of national income as possible to fund legitimate government programs.

With these rules in mind, let's have a look at the candidates' tax plans.

The Bush Plan

The Bush administration's main tax proposal in their 2005-2009 budgets is a call for Congress to make the 2001 and 2003 temporary Bush tax cuts permanent, rather than expiring between

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TaxWatch

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Message from the President: Welcome to *Tax Watch*

I'm thrilled to introduce you to the first issue of the Tax Foundation's newest publication, *Tax Watch*. Since 1937 our mission has been to inform Americans about the true cost of government. The aim of *Tax Watch* is to present our research in a simpler, less technical way. Look forward to *Tax Watch* continuing our tradition of telling the truth about taxes.

This year, our economists are working on several new projects. I'm sure you've heard repeatedly that the Bush tax cuts benefited the rich at the expense of low-income taxpayers. But did you know that the cuts knocked more than 7 million low-income families off the tax rolls?

Three years ago, we launched a program to provide facts like these to counter "class warfare" arguments against tax cuts. We call the program *Putting a Face on America's Tax Returns*, and you can read this issue's installment on page 5. Through it, our economists are helping paint a picture of the actual taxpayers behind the political slogans.

A second project is our *State Business Tax Climate Index*, which provides an objective measure of how business-friendly each state's tax system is. The aim is to show state legislators that complex and punitively high taxes can have severe long-term effects on their state's business climate.

Last year we released our first annual *Index*, and it had an immediate impact on tax debates, especially in America's most populous state of California, where Arnold Schwarzenegger publicized our results during his run for governor.

During the past 67 years, the Tax Foundation has earned the respect of the media, policymakers and taxpayers because we have stayed true to our mission to tell the truth about taxes. Thank you for your support, and I hope you enjoy the first issue of *Tax Watch*.

Sincerely,

Scott A. Hodge

"Jock Taxes" Continue Spreading to Non-Jock Professions

If state tax collectors have their way, we may all be "jocks" soon.

That's the finding of a new report from the Tax Foundation that explores the growth of "jock taxes"—taxes requiring visiting athletes and other team employees to file tax returns in every state where games are played.

"The jock tax began with California trying to get back at Michael Jordan and the Chicago Bulls for beating the Lakers in 1991," said David Hoffman, adjunct scholar with the Tax Foundation and co-author of the new report. "Illinois fought back with a retaliatory tax the next year. Since then, many other states have joined in."

Today, of the 24 states with pro teams, 20 have enacted jock taxes, along with a half dozen cities.

The study finds that revenue-hungry state treasuries are extending their income taxes to more and more nonresidents who just work a few days a year in their states. Jock taxes were first aimed at a tiny number of wealthy athletes, but the study shows they are now beginning to spread to salespeople, newspaper reporters, lawyers and others, forcing non-jocks to pay as well.

"Jock taxes were first aimed at wealthy athletes, but they're now spreading to other traveling professions—salespeople, home builders, reporters and more."

New Jersey has begun taxing visiting attorneys, Cincinnati has levied a tax on touring skateboarders, and several jurisdictions have begun taxing traveling entertainers.

"First, it was just Michael Jordan and the Chicago Bulls, then all professional athletes, and now trainers, scouts, lawyers, and even amateur skateboarders are being taxed when they leave their home state," said Hoffman.

Last year Patrick Hill, spokesman for the California Franchise Tax Board made the goal of the jock tax clear: "The tax isn't just on professional athletes. Even people with more-pedestrian lifestyles…are subject to this tax. A tradesman coming to build a building, or a reporter on assignment for a couple of months are subject to the tax as well."

Jock taxes are advertised as "soak-the-rich" taxes. But in reality, the jock tax nails everyone traveling with teams, including middle- and low-income trainers, coaches, and staffers with salaries ranging from $18,000 for scouts to $112,000 for team doctors.

The report was released July 9th to coincide with Major League Baseball's All-Star Game in Houston, Texas. Texas is one of the few states with a professional sports team that does not have a jock tax—along with Washington, Tennessee, and Florida—resulting in thousands of dollars of savings and reduced tax-paying complexity for players from around the country.

The study gives three major reasons the jock tax is ill-conceived:

- The tax is poorly targeted. Originally aimed at athletes, it has spread to people with moderate incomes, such as trainers and scouts, and other professions.
- The tax is arbitrary. Professionals in other occupations with comparable incomes over their working lives, such as doctors and corporate executives, are not penalized by a "doc tax" or "exec tax."
- The tax imposes an administrative burden on people who have to file more than a dozen state income tax returns.

"Texas is one of the few states without a jock tax, so that's good for players," said Scott Hodge, president of the Tax Foundation, "but those tuning in to this year's All-Star Game from the road on business better watch out. To state tax collectors, they may be 'jocks' too."

The full "jock tax" report is available at www.taxfoundation.org or by calling (202) 464-6200.

Key Tax Bills to Watch

H.R. 3184—"Streamlined Sales and Use Tax Act"

Sponsor: Ernest Istook (R-OK)
What it does: Forces Internet and catalog companies to collect state sales taxes from customers in other states.

S. 2281—"VoIP Regulatory Freedom Act"

Sponsor: John Sununu (R-NH)
What it does: Bans all states from taxing and regulating Internet phone calls.

H.R. 1308—"Tax Relief, Simplification, and Equity Act of 2003"

Sponsor: Bill Thomas (R-CA)
What it does: Range of targeted tax breaks, from bow-hunting and tackle boxes to families of the space shuttle crew. May also extend four expiring 2001 Bush tax cuts.

Tax Foundation in the Media

Spreading the message of low taxes and growth is part of our mission. Here's a sample of recent media appearances by Tax Foundation economists:

News Stories

Los Angeles Times, "High-Salaried Visitors Feel the Bite of the 'Jock Tax'"
New York Times, "The State-Tax Tug of War"
Boston Globe, "A Contest between Big Spenders"
Philadelphia Inquirer, "Pay to Play"
Christian Science Monitor, "Don't Mind Paying Taxes? You'd Love New England"
Atlanta-Journal Constitution, "Ideological Offspring Follow Reagan's Ideals"
Orange County Register, "FTB: F Stands for 'Fanatic'"
Sacramento Bee, "Basic Taxation Issue Lingers, Even in Schwarzenegger Era"
San-Diego Union Tribune, "Welfare Programs Targeted For Cuts"

Op-Eds

Barron's, "Rating Unemployment Rates" by John A. Tatom
Houston Chronicle, "The Jock Tax: A foe not even Clemens can fan" by Scott Hodge
Contra Costa Times, "Don't Let Cigarette Tax Hurt the Poor" by Justine Lam

Television & Radio

WIXL-Radio Orlando, Scott Hodge on the child tax credit
WTAQ-Radio Green Bay, Scott Hodge on Wisconsin state tax burden
KTSA-Radio San Antonio, William Ahern on John Kerry's tax return
ESPN SportCenter, David Hoffman on "jock taxes"
KHOU-TV Houston, William Ahern on "jock taxes"
KSEV-Radio Houston, Andrew Chamberlain on "jock taxes"

Visit our new "Press Room" at www.taxfoundation.org/pressroom.html.

Wacky Taxes

Taxes may be a fact of life—but they don't always have to make sense. Some of history's more bizarre tax-law oddities:

From Russia with Love

Russian czar Peter the Great returned from Europe in 1690 convinced that Russian men needed to "modernize"—including shaving their beards. He passed the famous "beard tax" as an incentive. The result? Beards became a status symbol. Other taxes Peter launched include taxes on burials, windows, and even "human souls."

Men Without Women

Using the tax code to promote marriage is nothing new. In 1695, the British passed the first tax on bachelors. More than a century later, Missouri followed suit in 1820—a $1 tax on men between the ages of 21 and 50 without wives.

Ancient Taxes

Salt was famously taxed by the ancients, but it wasn't the only commodity. As early as 2500 B.C. ancient Sumerians were taxed on cattle, fishing, and funerals. By 2000 B.C., Egyptians were taxing cooking oil. And around 1 A.D. Romans passed a tax on—of all things—urine.

Not surprisingly, Rome was also the first to imprison tax evaders—first ordered by Emperor Constantine in 306 A.D.

Putting A Face On America's Tax Returns

Are Business Owners the 'Rich'?

High tax rates may be aimed at soaking the rich, but if those so-called "rich" are small business entrepreneurs, the taxes may end up soaking the poor.

That's one of the findings of the forthcoming Tax Foundation report "Wealthy Americans and Business Income," by Scott A. Hodge and J. Scott Moody.

Today, more and more businesses are organized as sole proprietorships, partnerships and S-corporations.

"These companies don't file regular corporate income tax returns," said Hodge. "Instead, they file individual 1040s, with business profits taxed as personal income."

As more business income is taxed through the individual tax code, changes in rates—like the recent cut from 39.6 percent to 35 percent—become more important to the economy. In 1980, there were 13.3 million businesses filing through the individual income tax code. By 2002, there were more than 25.5 million—a 92 percent increase.

"Soaking wealthy taxpayers may end up penalizing small businesses and their employees."

Small businesses employ more than 30 million Americans. With so many small business owners falling into the highest income tax brackets, cuts in top marginal rates may have a dramatic impact on small business job creation.

"Since the 2001 cuts in top marginal tax rates, there's been an ongoing debate over how much those cuts will affect businesses who file taxes individually," said Moody.

Some scholars have argued that the 2001 Bush top marginal tax rate cuts did little for individual business owners and didn't impact job creation, while others argue that rate cuts are important for business.

The new report helps settle the debate, by using the Tax Foundation's Individual Tax Model and Matched IRS/Census Database to calculate how many Americans in the top income tax bracket are small business owners and employers.

A significant finding is that as taxpayers' incomes rise, so does the likelihood that they have some form of business income. That means cuts in top marginal tax rates can have a direct impact on job creation by small business.

Critics argue that top brackets only affect a small percentage of businesses. But individually owned businesses pay the lion's share of all individual income tax collections.

The report shows that business owners will pay an estimated 54 percent of all individual income taxes in 2004. Of the total amount of income taxes paid by business owners, 70 percent comes from high-income taxpayers—or "the rich." That means soaking wealthy taxpayers will end up penalizing small businesses and their employees.

"Since taxpayers with business income are shouldering such a disproportionate share of the tax burden, it's only logical that tax cuts will disproportionately benefit them," said Hodge. "Tax cuts can only aid those who pay taxes in the first place."

Some critics argue that high-income taxpayers with business income are merely "gentlemen investors" who have little impact on jobs and economic growth. If that were the case, one would expect to see clustering in one or a few occupations. But U.S. Census data show nearly the opposite.

"Overall the data show that high-income business owners are involved in nearly all occupations and industries in the U.S. economy," said Moody. "Such evidence does not support the notion that these taxpayers are somehow passive investors."

"The conclusion from these findings," he added, "is that lowering the top marginal income tax rates in 2001 did indeed benefit many highly taxed business owners—and the U.S. economy."

Advance copies of the forthcoming report ("Wealthy Americans and Business Income") are available by calling (202) 464-6200.

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2005-2011. The cuts Bush promises to make permanent include:

- The $1,000 child tax credit;
- The reduction in the "marriage penalty";
- The expanded 10 percent tax bracket;
- The increased ability of small businesses to expense investments;
- Cuts in the tax rates on dividends and capital gains; and
- The phasing-out of the estate tax by 2011.

The Bush plan also contains several proposals that would expand the use of tax-favored savings accounts, like 401(k)s.

The Kerry Plan

In various speeches, press releases, and on his campaign website, Sen. Kerry has laid out an extensive tax plan over the last several months. Though the complete details are unclear, to date his proposals include:

- A repeal of the Bush tax cuts on individuals with incomes over $200,000 by raising top marginal tax rates;
- Reversing the Bush plan to phase-out the death tax, raising the exemption level to $2 million in 2005;
- A refundable tax credit for higher education expenses;
- A two-year "new jobs" tax credit to cover employer's payroll taxes on new manufacturing jobs;
- A 1.75 percentage point reduction in the corporate tax rate;
- An end to tax liability deferral for foreign subsidiaries of multinational companies in an effort to curb "outsourcing" by U.S. companies;
- A refundable tax credit for small businesses who purchase health insurance for employees;
- A tax credit to fund health insurance for laid-off workers and early retirees;
- A tax credit for 20 percent of the cost of new energy-efficient building equipment;
- A tax credit for telecommunications companies that deploy broadband Internet connections to rural areas; and
- A tax credit to firms with employees who've been called up to active reserve duty.

> *"Both the Bush and Kerry plans are equally clear—or murky, depending on the interpretation—about who will benefit from tax breaks or rate changes."*

Comparing the Plans

How do the plans measure up to our principles?

Simplicity

By the first criterion of simplicity, neither plan looks especially attractive. Both the Bush and Kerry plans fail to noticeably streamline the tax code, and neither attempts any real tax simplification or reform of the Alternative Minimum Tax (AMT), which desperately needs restructuring. Although the Kerry plan introduces somewhat more complexity, both plans further complicate the existing tax code.

Transparency

Transparent taxes are visible to taxpayers and easy to measure. Although there are some murky elements in the Bush plan, overall it relies on simple across-the-board rate cuts, which are highly transparent. In contrast, the Kerry plan features an avalanche of targeted tax credits and rule changes, making it mostly inconsistent with the transparency rule.

Stability and non-retroactivity

Permanent tax cuts are good for stability; temporary ones aren't. The centerpiece of the Bush plan would make the 2001 and 2003 tax cuts permanent, which is consistent with the stability principle. The Kerry plan—by promising to revive the death tax, let the Bush tax cuts expire, repeal Bush's cuts in top rates, and introduce new temporary tax credits—is not consistent with the stability principle. The Kerry plan is packed with temporary tax changes, which make it impossible for taxpayers to plan for the future and can affect the long-term performance of the economy.

Neutrality

The centerpiece of the Kerry plan is a mixture of carrot-and-stick tax credits aimed at changing taxpayer behavior—a clear violation of the neutrality principle. Though the Bush plan also violates the neutrality rule with targeted tax cuts like

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the child tax credit, it does so in far fewer places than the Kerry plan. Also, the Bush plan would totally eliminate some taxes, like the death tax. The Bush plan would reduce discrimination in the tax code by making top tax rate cuts permanent, along with a flat 15 percent rate on capital gains and dividend income.

Growth-promotion

The Kerry plan has several tax reforms intended to promote economic growth. Kerry's plan to cut the corporate tax rate would make the U.S. more competitive globally. However, the plan's tax credits to manufacturers are less growth-promoting, as they help some industries at the expense of others. The Kerry plan would also penalize U.S. companies who compete in global markets overseas, harming domestic workers in those industries. Additionally, the Kerry plan would boost taxes on taxpayers earning $200,000 or more, which may cause slower job growth since many high-income taxpayers are also job-creating business owners who pay taxes through the individual income tax code.

The Bush plan, on the other hand, is aimed mainly at promoting economic growth through permanent across-the-board tax reductions and improved expensing for small business. Although some parts of Bush's plan aren't growth-oriented—like the child tax credit, which is good for families but has little impact on growth—overall the Bush plan is more consistent with the growth-promoting principle.

As you can see, the above principles help highlight important differences between the Kerry and Bush tax plans. Unfortunately, like most election-year tax plans they have much in common.

The bottom line is that both the Kerry and Bush plans fall far short of the fundamental tax reform America needs today.

Making Taxes Simple: the Laffer Curve

Econ 101 teaches that when a business cuts prices, revenue may go up or down. They'll earn less money per sale, but the price cut also leads to more sales. Whether total revenue grows or shrinks depends on which factor outweighs the other.

Governments face a similar problem with tax policy. Like price cuts, tax cuts can either shrink or expand revenue depending on how taxpayers react.

The Laffer curve shows the tradeoff between tax rates and tax revenue. The argument is simple: tax rates of zero percent and 100 percent will both generate no revenue. That means the "right" tax rate lies somewhere in between.

Tax cuts have two effects on total revenue—"arithmetic" and "economic". The arithmetic effect is that lower rates bring in less revenue per dollar of tax base. The economic effect is that lower taxes induce people to work more, expanding the tax base.

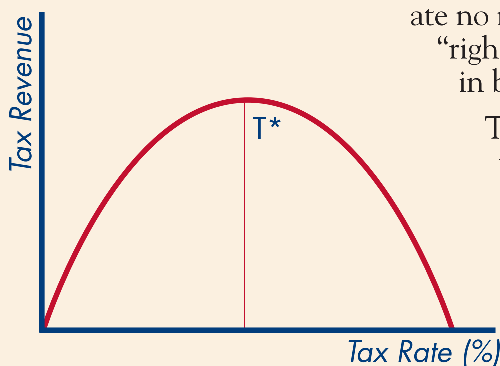
The name "Laffer curve" was coined in 1978 after economist Arthur Laffer. However, the idea behind it is ancient.

14th century Muslim philosopher Ibn Khaldun recognized that kings who imposed high taxes often caused revenues to fall. 19th century economist Frédéric Bastiat also beat Laffer to the idea.

In the 1980s, the Laffer curve helped give birth to "supply side" economics and the 1981 Reagan tax cut. The clearest demonstration of the Laffer effect came after the 1981 cut in capital gains tax rates, when revenues jumped 50 percent after rates were cut from 28 percent to 20 percent.

The Laffer curve is less popular in the media today, but it continues as a warning to governments that if taxes get out of hand, there may be nothing left to tax.

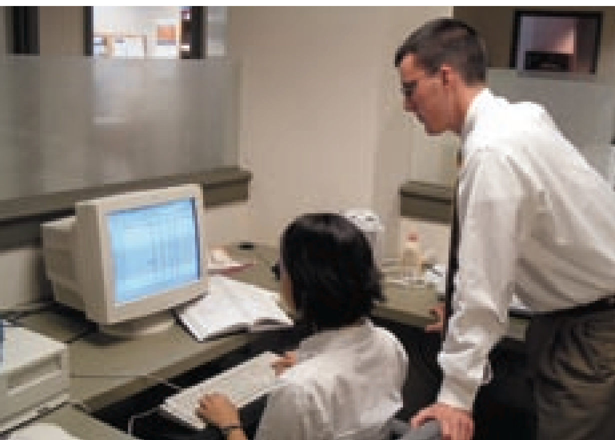
The Laffer Curve



Providing for the Future of Sound Tax Policy

An important part of the Tax Foundation's mission is reaching out to young leaders and introducing them to sound principles of tax policy.

As part of our internship program, the Tax Foundation invites college students from around the country to participate in research internships at our Washington, D.C. headquarters. Tax Foundation interns work side-by-side with staff economists—writing, researching, and learning to apply the Tax Foundation's pro-growth, free-market approach to tax policy.



"Tax Foundation: reaching young leaders."

This summer, the Tax Foundation welcomes three interns:

Nicole Akar is a student at Rice University in Houston, Texas, where she's studying economics. After graduating, she's hoping to pursue a career in either banking and finance or international affairs. "When I started my internship at the Tax Foundation, my knowledge of tax policy was very minimal," said Nicole. "I'm excited to be at a place with such a long-standing reputation."

Justine Lam graduated from University of California at Berkeley in 2001, and spent the last two years at a research firm in California. Justine plans to pursue a career in public policy in Washington. "This summer I chose to intern at the Tax Foundation because of my desire to learn more about public finance," said Justine. "I also believe in the Tax Foundation's principles that the tax code needs to be simple and promote economic growth."

Justin Slaughter is from Kennesaw, Georgia, where he attends Berry College and is double majoring in economics and math. Justin is hoping to pursue a career in public policy in Washington after graduate school in economics. "I knew that an internship with the Tax Foundation would provide invaluable research experience," said Justin. "I was elated to work alongside Tax Foundation economists."

As a Tax Foundation sponsor, your contributions help us train young leaders like Nicole, Justine and Justin, and help provide for the future of good tax policy. To learn how to make a special gift to fund a visiting student, please contact Julie Burden at (202) 464-5102.

Join us for the Tax Foundation's Annual Dinner

Mark your calendars—Thursday, November 18, 2004 in Washington, D.C., the Tax Foundation will host its Annual Dinner at the Four Seasons Hotel. Join us for the presentation of our Distinguished Service Awards for major contributions to tax policy. Space is limited—reserve your seat now by calling Julie Burden at (202) 464-5102.

Sixty Years Ago at the Tax Foundation

From our archives: A 1947 article "The Tax Foundation After Ten Years," by Prof. Raymond Moley of Columbia University.

"At the Tax Foundation's founding in 1937 … a bitter fight was going on. On one side were believers in economy. On the other were advocates of a novel economic theory which anticipated the death of private enterprise. Addressing the tax problem was an essential step toward saving ancient freedoms….

"The word 'liberal,' however it may have been abused in these years, may still be used to describe the spirit of the Tax Foundation. Governments have a way of growing too large, and when they do, taxpayers strike back. It is the duty of the Tax Foundation to remind people of the cost of their governments."