

BY AVIVA ARON-DINE

These are tough times, especially for low- and moderate-income families. For much of 2011, the unemployment rate exceeded 9 percent, and was higher among those without a college education. Last year, 15 percent of Americans lived in poverty, up from 12 percent before the recession. Meanwhile, the median income of working-age households fell sharply for the third year in a row. And that decline came on top of more than three decades of sluggish growth for all but the highest earners.

Yet to hear some people tell it, one of the major problems facing America is that the bottom half of U.S. families is getting off too easy. Every major candidate in the Republican presidential race, along with the Republican congressional leadership, has expressed outrage over the fact that 47 percent of households didn't owe any federal income tax in 2009. In announcing his presidential run, Rick Perry declared, "We're dismayed at the injustice that nearly half of all Americans don't even pay any income tax." Mitt Romney seemed to be working off the same script, telling supporters, "it's a real problem when you have half of Americans ... that are not paying income tax."

Those citing the 47 percent figure apparently don't feel obliged to explain why this statistic is so horrifying – perhaps because it's not easy to do so. For starters, there's no obvious reason why we should care about how

many people do or don't pay federal income taxes. Why not focus on the share of people paying payroll taxes (100 percent of those working, no matter how low their earnings), or the share paying federal excise taxes along with state and local sales taxes (pretty much everybody)?

To put it another way, the 47 percent figure can only be a problem if we like the solution – that is, if we think it would be fairer if the bottom half of households paid more tax. To evaluate that, we need to understand who these households are, why they don't owe federal income tax and what it would mean to demand more from them.

WHO PAYS WHAT?

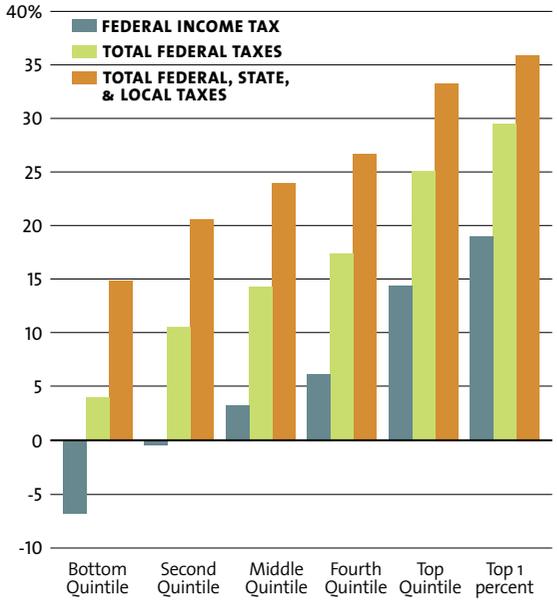
Cited in isolation, the 47 percent statistic creates the impression that half of households pay for government services, and the other half don't. This is simply not the case.

The figure on page 6 shows the shares of income paid in taxes by households. (The federal numbers come from the Congressional Budget Office, while state and local numbers

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SHARE OF INCOME PAID IN TAXES BY INCOME GROUP (2007)



SOURCE: Congressional Budget Office (federal taxes) and Citizens for Tax Justice Institute for Taxation and Economic Policy (state and local taxes)

were estimated by Citizens for Tax Justice’s Institute for Taxation and Economic Policy.) As expected, low- and moderate-income families don’t pay federal income taxes. Those in the bottom two-fifths of the income distribution actually pay “negative” income taxes on average – mostly because they are entitled to the Earned Income Tax Credit, a refundable credit intended to increase the purchasing power of low-income working families with children.

But the picture changes dramatically once other federal taxes are included. Everybody with income from work is liable for payroll taxes. And since Social Security levies aren’t charged on earnings above \$106,800, dishwashers pay a larger share of income in payroll taxes than, say, neurosurgeons. Federal excise taxes on gasoline, alcohol and tobacco also consume a larger share of income at the low

end of the distribution. When all federal taxes are taken into account, even the lowest fifth of households (with average incomes of about \$18,000) pay 4 percent of income in federal taxes, while the second-lowest fifth (average income: \$43,000) pay 11 percent. All these figures, by the way, net out the earned-income credit going to low-income households.

State and local tax systems are typically quite regressive, meaning that low-income families pay more of their income in taxes than higher-income families. That’s because states rely heavily on sales and excise taxes. And taxable purchases make up a higher fraction of income for low-income households than high-income ones, largely because the affluent save a larger fraction of their income. Even state income taxes (where they exist) are generally less progressive than the federal income tax: in 13 states, those with incomes below the poverty line pay some tax. When state and local taxes are taken into account along with federal taxes, the poorest fifth of households pays about 15 percent of income in taxes; the next fifth pays about 21 percent.

These figures give the lie to the idea that there is a large class of Americans who “don’t pay taxes.” To the contrary, they show that the federal income tax is one of the few taxes that doesn’t impose *higher* burdens on low- and moderate-income households than on upper-income ones. The overall U.S. tax system is progressive *only* because the federal income tax is very progressive. Put differently, we’ve chosen to concentrate almost all of the system’s progressivity in the Federal income tax.

As public policy, this approach makes a lot of sense. Imagine trying to make every component of the tax system progressive. Individuals would have to produce proof of income – and perhaps of how many dependents they had – every time they went to the grocery store or the gas station, and businesses would



have to compute customer-specific taxes accordingly. The IRS already collects this information, so it is far easier and cheaper to make the overall tax system progressive by offsetting the regressive effects of other taxes through the income tax. But having taken this approach, it makes no sense to put on blinders, look only at the federal income tax and express shock and dismay that so many people don't owe any.

WHAT WOULD IT TAKE TO MAKE MORE PEOPLE OWE INCOME TAXES?

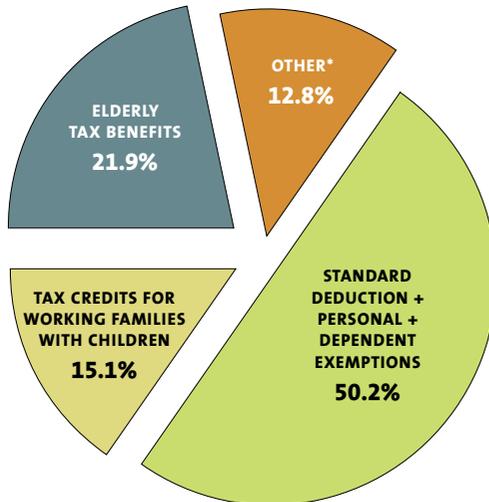
When presidential candidates describe the 47 percent statistic as an injustice, the clear implication is that it would be better if this figure were substantially reduced. So it's worth examining why so many people didn't owe fed-

eral income tax in 2009, and what steps would be involved in bringing that number down.

There is one approach to reducing the number of people who pay no income tax that we could all get behind, if we knew how to implement it: reducing unemployment. In 2007, 38 percent of U.S. households didn't owe federal income tax. Then the recession took hold, and millions lost their jobs. The tax structure automatically cushioned the blow; when households' incomes fell, so did their tax liability. Moreover, in an effort to stabilize the economy and help struggling families, Congress enacted additional measures, including the Making Work Pay Credit and the partial income tax exemption for unemployment benefits, which further reduced households' tax liability. These measures have

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REASONS HOUSEHOLDS DIDN'T OWE INCOME TAX IN 2011



*includes itemized deductions, middle-class tax benefits and low tax rates on capital gains

SOURCE: Urban Institute-Brookings Institution Tax Policy Center, "Why Some Units Pay No Income Tax," July 2011, <http://www.urban.org/uploadedpdf/1001547-Why-No-Income-Tax.pdf>.

now expired, but because the economy is still so weak, the non-partisan Urban Institute-Brookings Institution Tax Policy Center (the source of the much-cited 47 percent figure) projects that the share of households not owing income tax will remain at about 45 percent in 2012.

So the uncontroversial way to reduce the share of households not owing federal income tax would be to reduce unemployment and restore robust economic growth. Setting aside this (desirable but difficult) approach, the other methods to reduce the 47 percent figure would make a lot of people angry – and in many cases, rightly so.

To make real headway, policymakers would face some ugly choices:

Raise taxes on the elderly

At the height of the recession in 2009, older

households represented about a quarter of all those with no federal income tax liability. In a typical non-recession year, when more working-age people would owe income taxes, the elderly still represent nearly one-third of the non-paying group, even though just one-fifth of all households are elderly.

The main reason is that elderly people with modest incomes don't owe any tax on their Social Security benefits, and benefits are only partially taxable at higher incomes. Since most elderly households get most of their income from Social Security, just 55 percent of them owe federal income tax.

Not surprisingly, no elected official who values his or her job is singling out the elderly for a tax hike. Indeed, it is safe to say that these are not the people politicians have in mind when they rail against households that "don't have skin in the game." But unless policymakers raise this group's taxes, there will always be tens of millions of Americans who owe no federal income tax.

Reduce tax benefits for low-income working families with children

The Earned Income Tax Credit increases the incentive for low-wage workers with children to work by supplementing their earnings and offsetting their payroll tax and state and local tax burdens. (While a small credit is also available to very low-income workers without children, over 95 percent of the benefits go to families with children.) Low-income working families also benefit from the Child Tax Credit, although they often aren't eligible for the full \$1,000 per-child benefit received by middle-income families.

The earned-income credit provides the most help (up to about \$5,000) to working-poor families that wouldn't owe income taxes anyway because their earnings are too low. But for working parents with incomes be-



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tween the poverty line and twice the poverty line, the EITC and the Child Tax Credit offset federal income tax liability, as well as some of the burden of other taxes. For example, a single mother with one child does not owe federal income tax until her earnings reach about \$32,000.

If both credits were eliminated, the share of households not owing income tax would fall by about 15 percent. Of course, there would also be other effects. First, eliminating these two credits would drag some seven million people (among them, four million children) below the poverty line. And it would push the working families that are already poor into more desperate circumstances.

Studies of the expansions of the earned-income credit in the 1980s and 1990s found

that the extra incentive provided by those increases induced more than a half-million people to enter the labor force. In recognition of its successes, the EITC has been repeatedly expanded under administrations of both parties. Eliminating or cutting it would mean reversing what was once a bipartisan commitment to use the federal income tax to help “make work pay.”

Eliminate the standard deduction and personal and dependent exemptions

Even after dropping tax benefits for the elderly and income support for working families, about half of the original group of non-payers would remain. That’s because their incomes are less than the sum of the standard deduction and the personal and dependent

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exemptions allowed by the tax code, which generally means that their incomes are below (or barely above) the federal poverty line.

Historically, there has been a strong bipartisan consensus that families in poverty shouldn't pay federal income taxes (although this consensus has never covered people without children, and many childless poor do pay federal income taxes). In crafting the Tax Reform Act of 1986, policymakers made a deliberate decision to increase the standard deduction and personal exemption by enough to free poor households with children from income taxes. When he signed that bill into law, President Ronald Reagan actually bragged that the reform "removes six million poor people from the income tax rolls, making it one of the most effective antipoverty programs in our history."

But the consensus to which Reagan subscribed is apparently breaking down. Republican presidential candidates have repeatedly argued that everybody, presumably including the very poor, should pay a bit of income tax.

"Everybody should pay something" works as a political slogan because it sounds simple, fair and virtually painless. But in policy terms it would be deeply problematic, increasing taxes on those who can least afford it.

LOOKING BACK AND LOOKING AHEAD

While some conservatives have attacked the earned-income credit, few people are directly calling for large tax increases on the elderly or elimination of the standard deduction and personal exemption (although it should be noted that the latest round of flat tax proposals point in this direction). The real goal of the "stake in the system" rhetoric, I suspect, is to parry calls to raise the taxes of the rich. The logic is that the tax system is already overwhelmingly progressive, with rich people

shouldering too large a share of the burden.

Reasonable people differ about the appropriate degree of progressivity of the income tax. In part that's based on disagreements about equity (how much redistribution is fair?) and in part on technical disagreements (how much does progressivity distort incentives to work and to invest?). But a bit of perspective should go a long way toward narrowing the range of honest disagreement.

First, the federal tax system has become significantly less progressive over the last several decades, even as gaps in pretax income have widened dramatically. Since the late 1970s, income growth for low- and middle-income households has been sluggish. And over the last decade – even before the recession accelerated the trend – median household income for working-age households has actually fallen. Meanwhile, the rich have gotten much richer. The average real income of households in the top 1 percent more than tripled between 1979 and 2007, the latest year for which the estimates are available. (Losses during the downturn have offset only a small portion of those gains.)

Most Americans, I suspect, believe that taxes should become more progressive as the distribution of income driven by market forces becomes less equal – that is, tax policy should lean against the wind. Yet federal tax changes since the 1970s have done the opposite. According to the Congressional Budget Office, the top 1 percent paid 37 percent of federal taxes in 1979, compared with 30 percent in 2007 – a larger drop than for any other income group. Put differently, if effective federal tax rates had remained constant over this period, the average after-tax income of the top 1 percent would have risen by about \$850,000. In fact, it rose by almost \$1 million – reductions in federal tax rates chipped in the extra \$150,000.



Note, moreover, that simply maintaining current tax rates on high-income households in future decades would require an even more regressive shift in the overall fiscal system. The nation plainly faces serious budget challenges. While this year's high deficit is mostly a result of the recession, the large deficits projected for future decades reflect an unsustainable mismatch between revenues and expenditures. At some point, deficits will have to be reduced to sustainable levels through some combination of spending cuts and tax increases.

If none of the required deficit reduction can be achieved through tax increases on high-income households, then all of it will have to come from tax increases on low- and middle-income households and from program cuts, the burden of which would also fall disproportionately on low- and middle-income house-

holds (especially those that are elderly or disabled). Last year's House-passed budget resolution (the so-called "Ryan budget") provides an illustration of what such an approach would look like: voucherization of Medicare and deep cuts to means-tested programs, including Medicaid and food stamps, and to middle-class benefits like federal student aid.

Ultimately, the 47 percent statistic is just a distraction from important policy choices. We can close future deficits through spending cuts or tax increases, or a combination of the two. We can split the burden in myriad ways. And what you take to be the fair approach logically depends on your views on a variety of issues. But it doesn't depend on how many people fall on one or the other side of zero liability when they fill out their federal income tax returns. **M**