PERSONALLY SPEAKING

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FEDERAL INCOME TAX: WHO PAYS, WHO DOESN'T

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With the federal books closed on FY 2009 showing a $1.4 trillion budget deficit and a similar deficit projected by the U.S. Treasury for FY 2010, along with proposed legislation on health care reform driving up federal spending, Washington presents the American people with three options. Borrow more and push the public debt above its present level of $12.0 trillion, increase tax rates, or grow the economy. A closer look at one major source of federal tax revenues -- the individual income tax -- may shed some light on the feasibility of raising that tax.

An estimated 59,300,123 persons who filed federal income tax returns for 2007 paid no taxes that year. Based on data supplied online by the Internal Revenue Service those persons represent 30.1 percent of all persons who filed returns for 2007. These data are the latest available and include the known number of persons with income who did not have to pay taxes along with an unknown number of filers who underreported their income in order to evade paying taxes. A total of $615.4 billion or 7.1 percent of the $8.7 trillion reported as total adjusted gross income for 2007 was not taxed. Returns with approved tax credits represented 33.6 percent of all tax returns.

In 1996, the first year for which these IRS data are available online, there were 36,647,813 persons who had no tax liability representing 21.7 percent of all persons filing returns. A total of $194.1 billion or 4.3 percent of total adjusted gross income was not taxed. Returns in which the filers claimed tax credits represented 13.2 percent of all returns.

Thus, between 1996 and 2007 there has been a 62 percent increase in the number of persons with income who paid no federal income taxes, a 217 percent increase in the amount of income which was not taxable, and 203 percent increase in the number of returns claiming tax credits. At the same time there was only a 16 percent increase in the number of persons filing income tax returns. These data do not include new credits for first-time homebuyers and the *Making Work Pay* tax credit.

Even with these exclusions from taxable income, total individual income tax revenues jumped from $658 billion in 1996 to $1.1 trillion in 2007, demonstrating the powerful effect of economic growth which supply-side economists attribute to the Bush tax cuts.

Given the political attractiveness of tax credits to pay for worthy activities, and the president's campaign pledge not to raise taxes on persons with incomes below $250,000, it seems likely that any tax increase will fall on those with higher incomes.

In 2007 there were 8.3 million persons with adjusted gross income above $200,000 (the data are not available for $250,000+). At that high-end, only 0.2 percent had no tax liability. They paid taxes totaling $ 610.0 billion – an average of $73,083. Within this group there were 715,251 millionaires who paid a total of $310.0 billion in taxes or an average of $433,461. If all of these millionaires had to pay a 100 percent surcharge the additional revenue would cover only 22 percent of a $1.4 trillion deficit.

Mayo Research Institute expects that Washington will not hike income tax rates because tax increases slow economic growth cutting off a prime source of additional tax revenues. More and more special interests will petition the federal government for tax relief through tax credits. The Senate health care bill, for instance, contains a refundable tax credit to provide premium assistance for coverage under a qualified health plan. Even if the U.S. economy begins to grow again, tax revenues will fall short of spending, as happened in FY 2007 the last full year of economic growth in which there was a $163 billion budget deficit. It follows that deficit spending will continue in the years ahead and that the public debt will continue to grow.

When investors including notably the Chinese finally stop buying the securities issued by the U.S Treasury, the Federal Reserve will increase the money supply, inflating the dollar further and allowing the Treasury to service and redeem the debt in cheaper dollars. However, Americans will pay for this lack of fiscal discipline through higher prices and lower living standards unless their incomes grow faster than the rate of inflation. But inflation does not grow the economy. Entrepreneurs grow the economy by creating a demand for new goods and services and boosting demand for already established goods and services by finding ways to cut the cost of production and offering them at attractive prices. Innovation at best is problematical because it involves risk-taking. Are producers likely to take on the risks of entrepreneurship if they expect to be singled out for higher taxes? Is the Federal Reserve likely to slam on the brakes to bring inflation under control knowing that it will drive up the jobless rate? More and more the fiscal future appears to be inflation to manage the burden of the growing public debt and as every consumer knows first hand inflation is the cruelest tax of all.

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