

## The Myth of Income Tax Freeloading

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This year's tax season controversy surrounds the Tax Policy Center's estimate that 47% of households do not owe income tax. The estimate has raised concerns about equity (nearly half of families free-riding on the rest of us) and civic responsibility (can democracy work when half of voters get government for free?). It also just ticked off some people who feel they're bearing more than their fair share of the tax burden.

The percentage of people who don't owe income tax is especially high for a couple reasons. First, the recession has slashed many families' incomes, cutting their regular tax liability and making them eligible for income supports like the refundable child tax credit and the earned income tax credit (EITC). When the economy recovers, some will reenter the ranks of the taxed. Second, some of the economic stimulus measures, such as the "Making Work Pay" tax credit, were put forward as temporary measures to boost spending. If all the recent tax cuts are allowed to expire, income tax liabilities at the bottom will go up significantly.

Of course, income taxes are only part of the tax burden families face. For most people, Social Security and Medicare payroll taxes are bigger than income taxes. And state and local income, sales and property taxes hit lower-income families hard. The vast majority of Americans are paying taxes in some form.

But the 47% statistic also highlights a major change in our tax and transfer system over the past 30 years: Many social programs that would have been provided by program agencies like the Department of Health and Human Services are now delivered by the IRS. Consider that the EITC, the cash-assistance program for working-age families, is about as big as Food Stamps. More families benefit from the child and dependent care tax credit than from Head Start or subsidized child care. More families with children in college are eligible for college tax credits than for subsidized student loans or Pell grants.

This is not necessarily a bad thing, but it means that income tax filing really combines two functions: taxes and transfers. The Tax Policy Center estimated that before deducting special tax breaks more than 80% of households owe income tax. The one-fifth of households with no tax liabilities are almost all poor (removing them from the income tax rolls was an explicit policy decision of President Reagan in the 1986 tax reform).

That leaves 27% who do not owe income taxes because their subsidies are at least as great as their liability. They are not by any means the greatest beneficiaries of IRS-administered largesse. Tax breaks like the mortgage interest deduction, state and local tax deductions, deduction for charitable contributions and exclusion of contributions to pensions, 401(k) plans and employer-sponsored health insurance are much, much bigger and disproportionately flow to those with higher incomes.

Eric Toder, Chris Geissler and I estimated that those tax breaks--sometimes called "tax expenditures"--were worth 7% to 8% of income for low- and middle-income families in 2007. The biggest beneficiaries, though, were those with high incomes. Tax expenditures for the richest 20% were worth 11% of income. For the highest-income 1%, the subsidies amounted to almost 14% of income.

Given that low-income tax subsidies are raising the reward to work, helping families support children and pay for childcare, and providing assistance with higher education expenses, it's neither surprising nor disturbing that they are significant relative to income (and tax liability).

But I do think there is a problem with the way we account for tax subsidies for people at all income levels. We should break out the tax collection and social program functions of the IRS. It would be a big boost to transparency, might build support for tax reform and might dampen the tiresome rhetoric about tax system freeloaders.

I have a simple proposal: The IRS should report back to taxpayers what they paid in taxes and received in subsidies. (1) How much tax did each family pay in total and as a share of income before considering credits, exclusions and deductions? This would show that the vast majority of working families are shouldering a share of income tax liabilities. (2) What was the value of those credits, exclusions and deductions? This would show that families at all income levels are receiving a lot of welfare through the tax system.

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The reports might cause taxpayers to think about whether we could simplify the tax collection and welfare functions of the IRS, which would be very worthwhile. But the fact that low-income families are receiving their fair share of subsidies is a good thing--and especially necessary in these trying economic times.

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