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TAX FEATURES

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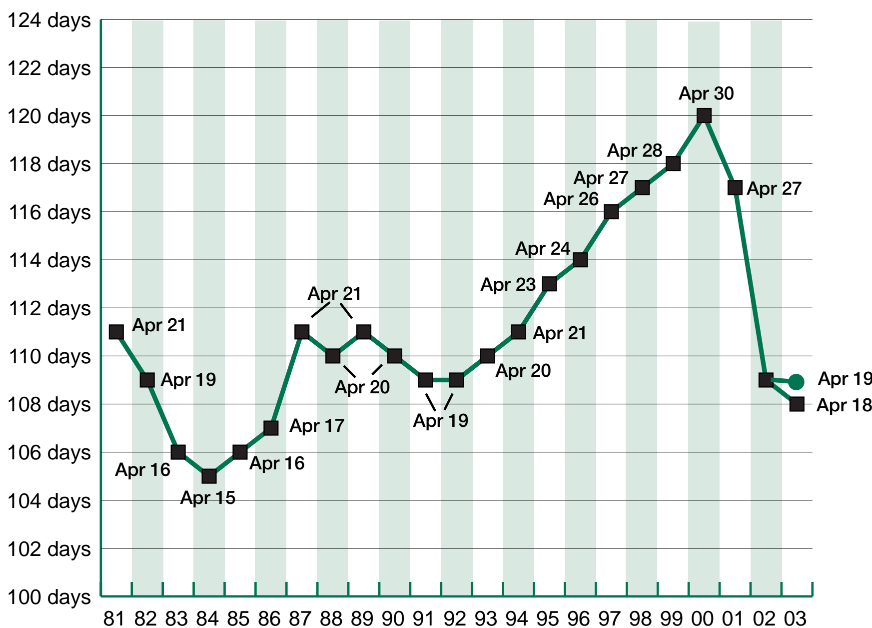
Spring 2003 Volume 47, Number 1

New Law Accelerates Rate Cuts on Wages and Drops Rate on Dividends and Capital Gains

Retroactive Tax Cut Moves Tax Freedom Day Earlier on the Calendar for the Third Consecutive Year

Originally announced to be April 19th, Tax Freedom Day Moved Back to April 18th with the New Tax Cut



See complete Tax Freedom Day info on page 8.

President Bush has signed into law the third tax cut of his first term.

The new law includes four provisions that merely accelerate into 2003 some changes that were already passed into law as part of the tax cut in 2001:

- ♦ Make all the income tax rate reductions from the 2001 tax law effective in 2003 instead of in 2004 and 2006 (see Table 1);
- ♦ Raise the child tax credit from $600 to $1,000 per child this year, instead of in 2010 (see Table 2);
- ♦ Reduce the marriage penalty this year, instead of in 2009, by raising the standard

See New Tax Cuts *on page 4*

New Publication

"State Business Tax Climate Index"

No. 41 in the Foundation's *Background Paper* series, this study ranks the tax "friendliness" of all 50 state tax systems. See article on page 2.

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FRONT & CENTER

Building a Level Playing Field for U.S. Exporters

Rep. Charlie Rangel (D-NY), Ranking Minority Member, Ways and Means Committee
Rep. Phil Crane (R-IL), Chairman, Subcommittee on Trade, Ways and Means Committee

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New Index Ranks State Tax Systems on How Friendly They Are to Business

In a new study, The State Business Tax Climate Index, the Tax Foundation ranks the 50 states on how "business-friendly" their tax systems were at the start of 2003.

Wyoming, New Hampshire, Nevada, Colorado, and Alaska are the five states found to have tax systems most conducive to new and expanding businesses, while Nebraska, Ohio, Arkansas, California and Mississippi have the five least hospitable tax systems (see Table 1).

"Tax competition among states is an unpleasant reality for state revenue raisers," said Scott Hodge, Executive Director of the Tax Foundation and lead author of the new study, "but competition is a godsend to taxpayers. The most effective restraint on state taxes is the knowledge that business will take jobs and prosperity out of state if taxes become unmanageable."

full study on line at

www.taxfoundation.org/bp41.pdf

States routinely assemble and publicize generous packages of tax abatements and public spending to lure large employers: baseball teams, auto plants or the corporate headquarters of a major firm. But under the media radar, each state's tax system is constantly competing with its neighbors for start-ups and business expansion without the benefit of special tax breaks. The *State Business Tax Climate Index* is designed to gauge which tax systems give their states a leg up in this competition.

The simplest measure of state taxes is the "tax burden," i.e., the percentage of all income taken by taxes. While businesses have always taken note of the Tax Foundation's annual tax burden estimates (www.taxfoundation.org/statelocal70-03.html), some have commented that the structure and complexity of a state's tax system is as important as the amount collected. The *State Business Tax Climate Index* gauges the economic damage caused by the manner in which each state extracts tax revenue.

"Tax competition among states may be unpleasant for state revenue raisers, but it's a godsend to taxpayers."

Co-authored with Hodge by Tax Foundation Senior Economist Scott Moody, M.A., and Adjunct Scholar Wendy Warcholik, Ph.D., the study appears as Number 41 in the Foundation's *Background Paper* series (see Publication Summary).

The basic premises are two:

1. *Taxes matter to business.* Taxes dramatically affect business decisions, job creation and retention, plant location, competitiveness, and the long-term health of a state's economy (see sidebar). For businesses, taxes are an input cost, just like the cost of raw materials. When costs rise, they are passed along to consumers (through higher prices), workers (through lower wages or fewer jobs), and shareholders (through lower dividends or share value).

2. *States do not enact tax changes (increases or cuts) in a vacuum.* Every tax change will in some way change a state's competitive position relative to its immediate neighbors and the region. Ultimately it will affect the state's national standing as a place to live and do business. Entrepreneurial states can take advantage of the tax increases of their neighbors to lure businesses out of higher–tax states.

The most competitive tax systems are usually found in states that raise sufficient tax revenue without one of the major taxes on sales, personal income or corporate income. The least competitive are found in states with complex, multi-rate corporate and

How Do Businesses React to Taxes?

In July 2002, New Jersey lawmakers attempted to close the state's mounting budget gap by enacting legislation that effectively doubled taxes on corporations. Shortly after the tax increase was enacted, James M. Zimmerman, Chairman of Federated Department Stores (which owns Macy's and Bloomingdales), wrote New Jersey Governor James E. McGreevey:

"Retailers such as Federated already are dealing with one of the most difficult economies in recent memory, and I can tell you unequivocally that we cannot and will not absorb a $5.7 million New Jersey tax increase without taking commensurate measures to reduce expenditures there."

Federated then announced that it would lay off 50 to 60 workers in New Jersey and possibly close a store or a distribution center to cut costs. In response to this news, the head of New York's largest business group wrote Zimmerman to encourage the retailer and other affected New Jersey businesses to redirect those jobs and investments to the Empire State, which had been cutting taxes to improve its business climate.

individual tax codes; above-average sales tax rates that exempt few business input items; high overall state tax burdens and revenues that have grown faster than citizens' incomes; and tax codes that impose considerable compliance costs on businesses.

Table 1: Business Tax Climate Index and Ranking, 2002

	Score	Rank
All States Plus DC	5.97	—
Wyoming	8.30	1
New Hampshire	8.05	2
Nevada	7.91	3
Colorado	7.69	4
Alaska	7.64	5
South Dakota	7.63	6
Florida	7.41	7
Washington	7.37	8
Oregon	7.20	9
Tennessee	7.04	10
Indiana	7.04	11
Massachusetts	6.90	12
Texas	6.75	13
Illinois	6.71	14
Delaware	6.58	15
Alabama	6.58	16
Arizona	6.46	17
Michigan	6.39	18
Pennsylvania	6.38	19
Vermont	6.36	20
Virginia	6.36	21
Montana	6.33	22
Missouri	5.89	23
North Carolina	5.85	24
Georgia	5.83	25
South Carolina	5.81	26
Oklahoma	5.80	27
Wisconsin	5.69	28
New Mexico	5.58	29
Rhode Island	5.55	30
Maryland	5.53	31
North Dakota	5.43	32
Idaho	5.43	33
Utah	5.40	34
Kentucky	5.37	35
Kansas	5.20	36
Connecticut	5.11	37
Iowa	5.10	38
West Virginia	5.10	39
New Jersey	5.09	40
Louisiana	4.87	41
Minnesota	4.84	42
Maine	4.83	43
New York	4.80	44
Hawaii	4.73	45
Nebraska	4.67	46
Ohio	4.45	47
Arkansas	4.43	48
California	4.36	49
Mississippi	3.97	50
District of Columbia	4.55	—

Source: Tax Foundation

The Purpose of the State Business Tax Climate Index

This year, dozens of states are facing mounting deficits, and the reflex of many lamakers is to raise taxes in order to close these budget gaps. While raising taxes may solve a state's budget-balancing problems in the short run, lawmakers must consider the long-term damage these actions can have on the state's business climate and economic health.

The *State Business Tax Climate Index* provides business leaders and government policy-makers a comparative gauge of their state's tax system that measures how much their state tax system is hampering either the efforts of local entrepreneurs or the possible entry of new business.

How the State Business Tax Climate Index is Calculated

The touchstone of the State Business Tax Climate Index is neutrality. If a state's tax system maintains a "level playing field" for all types of businesses and business transactions, the Index rates it highly. An economically neutral tax system benefits and punishes all businesses equally, so this index is a measure of each state's tax friendliness to all business activity, not just small businesses or large businesses, capital-intensive or service-intensive, existing companies or start-ups.

Therefore, if a state's tax burden is relatively low and the state's tax system does not favor some economic activities while penalizing others, we conclude that the state's economy will be comparatively efficient and yield higher incomes for everyone.

As difficult and desirable as tax neutrality is to achieve within a state, it is far more difficult to achieve between states. Tax competition is an unpleasant reality for state revenue and budget officials but a godsend to taxpayers, because it is probably the most effective restraint on state and local tax burdens.

The overall index is a composite of five specific indexes devoted to major features of a state's tax system, features that definitely influence business decisions or the economy in general: the corporate income tax, the individual income tax, the sales and gross receipts tax, the state's fiscal balance, and the administrative complexity of the state's tax system as measured by its conformity with other systems. These five indexes are themselves composites of several sub-indexes.

The common characteristics of states that rank poorly are: multiple-rate corporate and individual tax codes that impose above-average tax rates; above-average sales tax rates that exempt few business input items; high overall state/local tax burdens that have grown faster than taxpayers' incomes; and tax codes that impose considerable compliance costs and double-taxation on businesses.

Not all taxes that affect business are included. From future research into state taxation will emerge new variables and indexes to include in future editions of the *State Business Tax Climate Index*.

Publication Summary

General: Background Paper No. 41; ISSN 1527-0408; 28pp.; $25 or $60/yr. for at least four papers on varied fiscal issues

Title: State Business Tax Climate Index

Author: Scott Hodge, J. Scott Moody, M.A. and Wendy Warcholik, Ph.D.

Date: May 2003

Subject: A ranking of the 50 states in order which tax systems are most conducive to business growth

Tables: State Business Tax Climate Index, 2002; Major Components of the State Business Tax Climate Index, 2002; Corporate Income Tax Index and Ranking, 2002; Individual Income Tax Index and Ranking, 2002; Sales and Gross Receipts Tax Index and Ranking, 2002; Fiscal Balance Index and Ranking, 2002; Tax Base Conformity Index and Ranking, 2002; Corporate Income Tax Index and Ranking, 2002; State Corporate Income Tax Rates as of December 31, 2002; State Individual Income Tax Rates as of December 31, 2002; State Sales Tax Rates and Exemptions for Agricultural, Manufacturing and Machinery Inputs as of December 31, 2002; State Sales Tax Exemptions for Services, Software, Leasing and Rental Inputs as of December 31, 2002; State and Local Fiscal Balance Indicators, 2002; Tax Base Conformity Indicators: Tax Deductibility; Other Tax Base Conformity Indicators, 2002

New Tax Cuts

from page 1

deduction and the ceiling of the 15-percent bracket for married couples filing a joint return (see Table 3);

♦ Raise the amount of income subject to the new, lowest tax bracket of 10 percent from $6,000 to $7,000 for individuals, and from $12,000 to $14,000 for couples, instead of in 2008.

The new law also has some new provisions also:

♦ Lower the tax rate on long-term capital gains from 20 to 15 percent.

♦ Tax dividend income at the same rate as long-term capital gains, instead of counting it as regular income;

♦ Raise from $25,000 to $100,000 the amount of equipment purchases that small businesses can write off as expenses;

Except for the capital gains tax cut, which affects all gains on or after May 6, 2003, all the provisions are retroactively effective to January 1, 2003. Because many Senators were unwilling to enact a large tax cut, all provisions are temporary, and their expiration dates vary (see Table 4).

Table 1: Income Tax Rate Reductions, Old Law vs. New Law

Old Law: Gradually Lowering Income Tax Rates

2003	27%	30%	35%	38.6%
2004–2005	26%	29%	34%	37.6%
2006–2010	25%	28%	33%	35%

New Law

2003–2010	25%	28%	33%	35%

Note: After 2010, all income tax rates are scheduled to revert to their 2000 levels: 28%, 31%, 36% and 39.6%.

Table 2: Raising the Child Credit, Old Law vs. New Law

	Amount Each Tax Return Can Subtract from Taxes Due, Per Dependent Child Under 17	
Calendar Year	Old Law	New Law
2003–2004	$ 600	$ 1,000
2005–2008	$ 700	$ 700
2009	$ 800	$ 800
2010	$ 1,000	$ 1,000
2011-	$ 500	$ 500

Table 3: Marriage Penalty Relief, Old Law vs. New Law

	Standard Deduction for Couples as a Percentage** of Standard Deduction for Singles	
Calendar Year	Old Law	New Law
2003–2004	167%	200%
2005	174%	174%
2006	184%	184%
2007	187%	187%
2008	190%	190%
2009–2010	200%	200%

	Top End of the 15-Percent Rate Bracket for Couples as a Percentage** of Top End for Singles	
Calendar Year	Old Law	New Law
2003–2004	167%	200%
2005	174%	174%
2006	184%	184%
2007	187%	187%
2008	190%	190%
2009–2010	200%	200%

* Note: Couples are assumed to file a joint return.

** Note: The actual dollar amount of the standard deduction and the dollar amounts that mark the end of each tax bracket are calculated by the IRS at the end of each year to account for inflation, so the increases in each of them for couples are presented as a percentage of the value for singles.

Faster Implementation of Lower Income Tax Rates

The income tax reductions have the longest life -- they will expire at the end of 2010. Table 1 shows how the rate cuts that would have been become law in 2004 and 2006 are effective for 2003.

Faster Increase in the Child Credit

In 1997, Ways and Means Chairman Bill Archer (R-TX) ushered into law the only significant tax cut to become law during the Clinton years. Its largest provision was a new income tax credit of $500 per child under 17.

As part of his tax cut proposal in 2001, President Bush asked for an increase in the child credit to $1,000, and it was enacted. Like the rate cuts, this change was planned to take effect in stages to make the overall tax cut smaller.

The credit would have been $600 during 2003 and 2004. The new tax cut makes it $1,000 instead of $600 for just those two years. This extra $400 per child per year will be delivered to taxpayers in the form of a government check in 2003 if they would have qualified for it in 2002.

Cutting Income Taxes for People Who Don't Owe Any?

Almost 40 million tax returns will show nothing owed to Uncle Sam in 2003 after passage of President Bush's new tax plan. That is almost 27 percent

of the country's tax filers. If these tax filers have had taxes withheld from their paychecks during the year, they'll get all of it back, and most will get a check because of the Earned Income Credit.

Because of the many dependent children on these returns, the number of people represented by returns with zero tax liability will rise about 12 million — from 69.6 to 82.0 million.

As signed into law on May 29, the new tax cut will only direct that $400 child tax credit checks be sent to taxpayers who paid some tax in 2002, but a new bill is working its way through Congress to send $400 checks even to non-paying tax filers. See sidebar.

Statistics on non-paying filers:

- 46.7%, or 16.7 million, claim the child credit (total people in these households = 55.4 million);
- 74%, or 26.5 million, benefit from the Earned Income Credit;
- 23%, or 8.3 million, are single individuals;
- 5.6%, or 2 million, are childless couples, either seniors or working couples; and
- 12%, or 4.3 million, have some business income (Schedule C).

After 2004, the amount of the child tax credit reverts to the schedule established in 2001: $700 from 2005-2008, then $800 in 2009, then $1,000 in 2010, and then back down to $500 (see Table 2).

As was the case under the old law, higher-income taxpayers get no benefit from the child tax credit because it is phased out for single filers with adjusted gross incomes (AGI) over $75,000 and joint filers with AGIs over $110,000.

Faster Marriage Penalty Relief

Two-income married couples with similar incomes have been paying higher income taxes than if they were unmarried, filing single tax returns (see example below).

The two provisions most often responsible for this "marriage penalty" are the standard deduction and the width of the 15-percent tax bracket. These two problems were fixed as part of President Bush's 2001 tax cut package, by

- Raising the standard deduction for couples to twice that of the standard deduction for a single filer; and
- Widening the 15-percent tax bracket for married couples so that it includes twice the income of the single filers' 15-percent bracket.

These fixes were scheduled to phase in slowly, but the new tax cut makes the fix immediate.

Eliminating the marriage penalty completely is harder than it sounds because it is not an actual additional tax. More than 60 provisions of the tax code vary with marital status, some causing higher taxes and some lower. Because the federal income tax code is "progressive," (tax rates rise with income), it can never be evenhanded for all taxpayers before and after marriage. Although the President's marriage penalty relief greatly reduces the number of people who pay more when married, only a greatly simplified tax code could avoid the problem entirely.

Lowering the Tax on Dividends and Capital Gains

A major component of the new law is a tax break on dividends and capital gains. In years past, the tax treatment of dividends has varied from fully exempt to partially exempt to fully taxable, and they've been fully taxable since 1985.

The new tax law will subject taxable dividends and capital gains to a 15-percent rate, or 5 percent if the person receiving the dividend has a low income.

Some press accounts have mistakenly reported that few people receive taxable dividends. According to the most recent IRS data, 34.1 million tax returns declared some taxable dividend income in 2000, representing 71.0 million people — 26.4 percent of the nation.

Nearly half (45.8 percent) earned less than $50,000 when income is measured as adjusted gross income which includes dividends. If we count just wages and salaries, 63.8 percent of taxpayers claiming dividends earned less than $50,000.

Of those 34.1 million tax returns with dividend income, 13.1 million also had some self-employment or small business income reported.

Expirations Abound

Every tax cut President Bush has signed will expire after 2010, and many of the newest tax cuts will expire sooner. Table 4 lists the major expirations and Table 5 shows the impact on the median family if the biggest expiration on December 31, 2010 is allowed to occur.

Table 4: Expiration Dates for Tax Laws

What Happens	When
Child Tax Credit Dips	Dec. 31, 2004
Marriage Penalty Rises	Dec. 31, 2004
Dividend Tax Rises	Dec. 31, 2008
Cap Gains Tax Rises	Dec. 31, 2008
All Bush Tax Cuts Expire	Dec. 31, 2010

Table 5: How a Typical Family of Four's Taxes Will Change When All the Bush Tax Cuts Expire After 2010

	2002	2010	2011	2010–2011 Absolute Change	2010–2011 Percentage Change
Adjusted gross income	$ 65,058	$ 79,189	$ 81,169	+ $ 1,980	+ 2.5%
Standard deduction	$ 7,850	$ 11,281	$ 9,656	– $ 1,625	– 14.4%
Total personal exemptions	$ 12,000	$ 14,488	$ 14,850	+ $ 362	+ 2.5%
Taxable income	$ 45,208	$ 53,420	$ 56,664	+ $ 3,244	+ 6.1%
Tax due before credits	$ 6,181	$ 7,278	$ 8,500	+ $ 1,222	+ 16.0%
Total child tax credits	$ 1,200	$ 2,000	$ 1,000	– $ 1,000	– 50.0%
Total income taxes due	$ 4,981	$ 5,278	$ 7,500	+ $ 2,222	+ 42.1%
Effective tax rate (total fed. inc. taxes due divided by inc.)	7.7%	6.7%	9.2%	+ 2.6%	+ 38.6%

Assumptions: Current law; family takes the standard deduction and claims no childcare credits.

Building a Level Playing Field for U.S. Exporters

FRONT & CENTER

by U.S. Representatives Phil Crane (R-IL) and Charlie Rangel (D-NY)

As in many countries, the tax law in the U.S. has long provided benefits to exporters. For most of the last two decades, these tax benefits were provided under the Foreign Sales Corporation (FSC) regime, but FSC had a predecessor, the Domestic International Sales Corporations regime (DISC), and a successor, the Extraterritorial Income regime (ETI). All three have been successfully challenged in international forums as illegal export subsidies by our trading partners.

There is no partisan Republican or Democratic position on this issue. There is, however, an American position and a European position. As a result, the U.S. must find a new, bipartisan solution.

The History of the Dispute

Starting in 1971, the United States provided tax benefits to corporations known as Domestic International Sales Corporations (DISCs), exempting so-called DISC income from corporate income tax, and partially deferring the shareholder-level tax on that income.

Certain signatories to the General Agreement on Tariffs and Trade (GATT) challenged the DISC regime as a prohibited export subsidy. A GATT panel agreed but also struck down some export tax incentives provided by France, Belgium and the Netherlands. The disputes that followed these rulings led to a 1981 GATT Council Decision, the "1981 Understanding," which was understood to qualify those findings in three principal ways:

(1) GATT signatories are not required to tax export income that is attributable to economic processes occurring outside their territorial limits; (2) "arm's length" transfer pricing principles should be observed in transactions between exporting enterprises and related foreign buyers; and (3) GATT does not prohibit the adoption of measures to avoid the double taxation of foreign-sourced income.

The debate over the DISC regime picked up again, with the U.S. claiming that in light of the 1981 Understanding, the U.S was merely approximating the effect of territorial tax systems commonly used by European countries. Eventually, however, the U.S. did replace the DISC regime with the FSC regime, and no challenge was raised until 1998.

In addition to providing tax benefits to domestic corporations, the FSC regime provided tax benefits for export-related income earned by foreign corporations that were required to have a foreign presence and to perform export-related activities outside the United States. It did this by allowing a partial tax exemption for the income of a foreign corporate subsidiary derived from handling U.S. export sales. It amounted to tax relief of roughly 5.25 percentage points off the otherwise applicable tax rate (the corporate tax rate today is 35 percent).

The European Union (EU) eventually asserted that FSC constituted an illegal export subsidy under new World Trade Organization (WTO) agreements. In 1999, a WTO panel agreed and in early 2000, a WTO appellate body upheld that finding.

In a bipartisan response in November 2000, the United States passed legislation to phase out the benefits of FSC and enacted the Extraterritorial Income (ETI) regime. It excludes from U.S. taxation certain foreign-source income, specifically a portion of export earnings and a portion of earnings from production abroad.

Even before Congress enacted the ETI regime, the EU announced that it intended to challenge it as well. It did so, and on January 14, 2002, a WTO appellate body agreed. Furthermore, in August 2002, a WTO arbitration panel determined that the EU was entitled to over $4 billion of annual retaliatory countermeasures against the U.S. if the ETI rules were not scrapped or amended.

The EU has not yet retaliated but it has released the final list of products it would target. The list includes steel, beef, sugar, wood and paper products, cotton, apparel, cosmetics and electrical machinery. While the EU would find it politically difficult to impose the full level of sanctions because of their rebound effect on EU businesses and consumers, these sanctions would be devastating to U.S. businesses and consumers.

The WTO rulings require a Congressional response, and there is a strong consensus that we should repeal FSC/ETI. We believe any replacement must provide transition relief to current FSC/ETI beneficiaries and support U.S. jobs.

The FSC/ETI provisions currently benefit companies manufacturing and producing goods in the United States, supporting over 1 million U.S. jobs directly and almost 2.5 million more indirectly. Merely repealing FSC/ETI would raise the tax burden of current beneficiaries by at least $50 billion over ten years, potentially resulting in further job losses in the already beleaguered U.S. manufacturing sector and effectively transferring jobs to Europe. This would be unacceptable.

Solution: H.R. 1769, the Crane-Rangel-Manzullo-Levin Bill

On April 11, 2003, we joined with our colleagues Donald Manzullo (R-IL) and Sander Levin (D-MI) to introduce H.R. 1769, the Job Protection Act of 2003. The legislation is nearly revenue neutral, costing the government only $126 million over 10 years. To date, 115 Members of Congress have cosponsored our legislation, which does three things.

- Immediately repeals FSC/ETI.
- Provides transition relief.
- Establishes a permanent tax benefit for manufacturing in the U.S.

The Job Protection Act of 2003 would repeal the current-law FSC/ETI benefit, effective for transactions after the date of enactment.

In a five-year transition, H.R. 1769 would provide tax relief based on a company's average FSC/ETI benefit during 2001. A company would receive a deduc-

Reps. Phil Crane, Republican of Illinois, and Charlie Rangel, Democrat of New York, are both longtime Members of the House Ways and Means Committee.

tion for 100 percent of its base period amount (indexed for inflation) for 2004 and 2005, 75 percent for 2006 and 2007, and 50 percent for 2008.

The legislation would not affect transactions pursuant to binding contracts in effect on the date of the legislation's introduction. This would affect few companies but ensures that pre-existing arrangements of U.S. taxpayers are not retroactively penalized.

On a permanent basis, a new deduction would reduce the effective corporate tax rate on the portion of a company's taxable income that's attributable to "U.S. production activities," defined as the manufacture, production, growth, or extraction of property of a type eligible for the current FSC/ETI benefit. It would apply whether or not the property is exported and would not have a domestic content requirement.

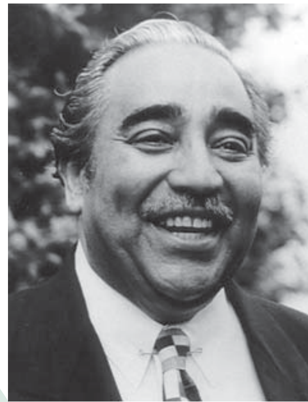
To calculate the portion of taxable income attributable to U.S. production activities, inventory costs, directly allocable deductions, and a *pro rata* portion of other deductions would be subtracted from total gross receipts from sale, rental or license of certain property produced in whole or part by the taxpayer in the United States. Allocation would be done in a manner similar to the method used in allocating deductions between U.S. and foreign source income.

For companies with 100 percent domestic production, the effective rate reduction would be $3^1/_2$ percentage points once fully phased-in (the 35 percent corporate tax rate would effectively be reduced to $31^1/_2$ percent). Other companies would receive a sliding-scale effective rate reduction based on the value of their U.S. production of eligible products compared to the value of their worldwide production.

Consistency with U.S. Trade Agreements

Taxpayers are eligible to benefit from H.R. 1769 even if they don't export a single product, thereby correcting the primary flaw of the FSC/ETI program from the standpoint of the WTO, whose rules prohibit subsidies "contingent… upon export performance."

H.R. 1769's permanent deduction and the resulting lower effective tax rate are also consistent with other WTO requirements. In addition to its export-contingency complaint, the EU argued that the FSC/ETI program was "contingent… upon the use of domestic over imported goods" ("import substitution subsidies" in WTO-parlance) and was thus prohibited by WTO rules.



Under the Crane-Rangel-Manzullo-Levin bill, taxpayers purchasing inputs from third parties would be indifferent between domestic and foreign goods.

The general transition relief provided between 2004 and 2008 is also WTO-consistent. The EU has taken no formal position on it, but the bill's U.S. opponents have asserted that the transition relief is "tainted" because the benefit calculation is based upon FSC/ETI benefits in 2001, when the benefits were found to be export-contingent.

The general transition relief in H.R.1769 is not "tainted" in any way because it is not a continuation of the FSC/ETI program. Manufacturers are not required to export anything to receive the benefit, and as the WTO Subsidies Agreement states: "The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision." In fact, the argument that these transition benefits are tainted is mostly heard from those who advocate for new benefits for the offshore operations of U.S. firms at the expense of U.S.-based manufacturing.

The standard legal meaning of "contingent" is "possible, but not assured, doubtful or uncertain, conditioned upon the occurrence of some future event which is itself uncertain." The general transition relief is not doubtful or uncertain, and it is not conditioned upon any future event.

H.R. 1769 creates a lower effective rate on a certain type of income. No WTO or other international obligation limits a government's ability tax different types of income at different rates (so long as the distinctions are not trade-related). This bill favors income from investment and production activities in the United States, as do numerous other provisions in the U.S. tax code.

Finally, it is important to note that the U.S. agreed to allow the EU a five-year transition period after a WTO dispute that the EU lost (the *Bananas* case). It would be difficult to justify an argument that the United States should not be permitted a similar transition period.

Conclusion

The pending $4 billion sanction against U.S. products is massive, but we have faced similar challenges to our export-related benefits in the past. We have always responded in a bipartisan, bicameral manner, which is appropriate because that type of challenge is not the normal partisan issue. It is a legal dispute between our country and our foreign competitors. In that dispute we all represent the same client, the United States.

H.R. 1769 will comply with the WTO ruling by repealing the FSC/ETI benefit, but it also will provide a permanent effective rate reduction for U.S. manufacturers in a way that is consistent with our trade agreements. It will preserve, not threaten U.S. jobs. Surely, that is a goal we should all support.

The Tax Foundation invites national leaders from all perspectives to contribute columns to Tax Features*. The opinions expressed are not always those of the Tax Foundation.*

April 18, 2003 Is America's Tax Freedom Day®

Date Means U.S. Works 108 Days to Pay for Government, One Day Less Than in 2002, Twelve Days Less Than in 2000

Americans celebrated Tax Freedom Day® on April 18, 2003. That is one day earlier than in 2002 and 12 days earlier than in 2000 when taxes reached their post-war peak (see line chart on page 1).

CNN's Lou Dobbs used Tax Freedom Day on his show *Moneyline* to explain the impact of the Bush tax cuts on America's tax burden.

In the new report, *Tax Foundation Special Report No. 122*, "America Celebrates Tax Freedom Day," senior economist Scott Moody explains why the overall tax burden has been trending down the last three years, pushing Tax Freedom Day back into mid-April, after a long string of later and later Tax Freedom Days.

"Two factors are combining to make the average American tax burden lighter in 2003," said Moody, "federal tax reductions and a slower economy."

In fact, when the report was first issued in early April, Tax Freedom Day was announced to be April 19th, but the retroactive tax cut signed into law on May 29 provided Americans with one more day of tax freedom.

On the down side, the slack economy has also played a role in forcing the tax burden down. When incomes don't grow, tax revenue flags too, and slow growth in recent months has arrested the growth of tax collections by federal, state and local governments.

From 1992 when Tax Freedom Day fell on April 19, until 2000 when Tax Freedom Day hit April 30, the tax burden grew markedly, requiring 12 extra days of work from American taxpayers. With state taxes steady over that period, all the increase was due to the rapid growth of federal tax collections.

Taxes and Other Expenses

The pie chart below uses the number of days worked as a yardstick to measure the price of government against the price of other important categories of consumer spending. Americans will work longer to pay for government (108 days) than they will for food, clothing, and shelter combined (105 days).

Only in the last decade have taxes exceeded spending on these basic necessities, and federal taxes alone cost Americans more (73 days) than any of the other major budget item.

The Origin and Popularity of Tax Freedom Day

The concept of Tax Freedom Day was invented in 1948 by Florida businessman Dallas Hostetler. He copyrighted the name and calculated Tax Freedom Day himself for many years. Upon retirement in 1972, he assigned

Publication Summary

General: Special Report No. 122; ISSN 1068-0306; 16pp.; $10 or $50/yr. for at least 6 Special Reports on varied fiscal issues

Title: America Celebrates Tax Freedom Day®

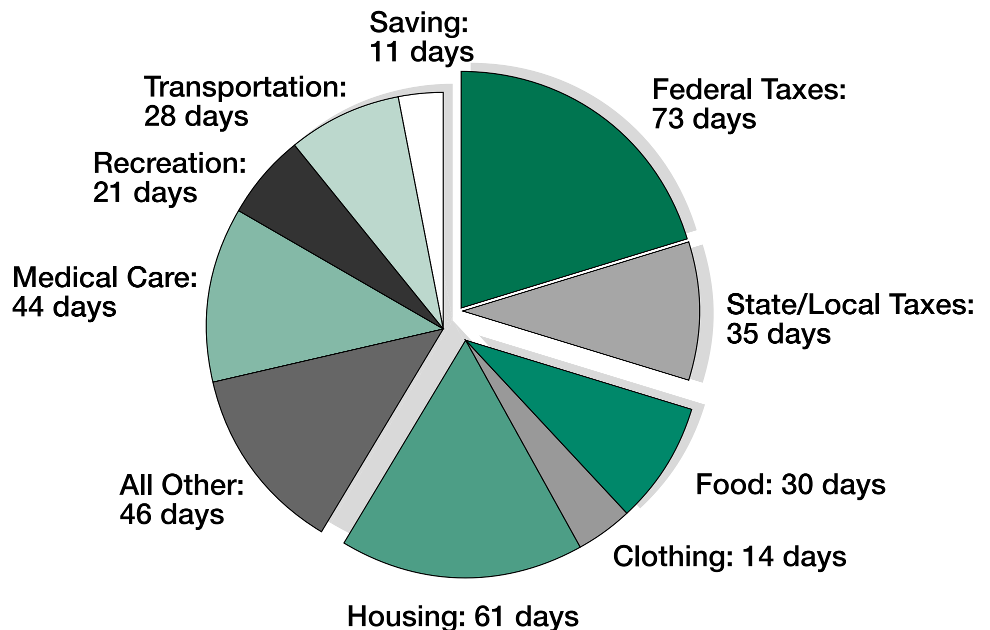
Author: J. Scott Moody

Date: April 2003

Subject: Calculation of the total effective tax rate for the United States, and for each of the 50 states plus the District of Columbia

Tables: Tax Freedom Day & Total Effective Tax Rate by Level of Government, 1900–2003; Tax Freedom Day by State and Rank, 1970–2003; Tax Freedom Day by State, by Rank, 2003; Days Spent Working to Pay All Taxes in Each State, Total Taxes as a Percentage of Income, Per Capita and Rank, 2003; Days Spent Working to Pay Federal Taxes in Each State, Federal Taxes as a Percentage of Income, Per Capita and Rank, 2003; Days Spent Working to Pay State/Local Taxes in Each State, Per Capita and Rank, 2003; Number of Days Americans Have to Work to Earn an Amount Equal to Federal Income Tax Compliance Costs, 2003; State and Local Tax Incidence Results by State, 2003

How Long Americans Work to Pay Taxes Compared to Other Major Spending Categories, 2003



Source: Tax Foundation calculations using Department of Commerce consumption data.

the intellectual property rights to the Tax Foundation which has promoted the concept ever since.

The idea has spread around the world, with independent research groups in India, Great Britain, Canada, and several other nations calculating their national Tax Freedom Day.

How the Date is Computed

Tax Foundation economists project the nation's effective tax rate, 30 percent this year, then apply that percentage to a calendar year, providing a graphic illustration of how long Americans work for government.

The income figure used is Net National Product (NNP), computed annually by the Commerce Department's Bureau of Economic Analysis (BEA). BEA revises its entire historical series frequently, so the new report on Tax Freedom Day is the only valid source for historical or current data used to calculate Tax Freedom Day, either at the national or state level.

Computing Tax Freedom Day State-by-State

The tax burden borne by different states varies considerably, not only because residents of different states face different state and local taxes, but also because they pay dissimilar federal taxes. The map below and Table 1 give each state's Tax Freedom Day, including all federal, state and local taxes.

Connecticut's total tax burden is the heaviest, mostly because of high income and the resulting high federal taxes, although state and local taxes also contribute to the long delay of Tax Freedom Day until May 9.

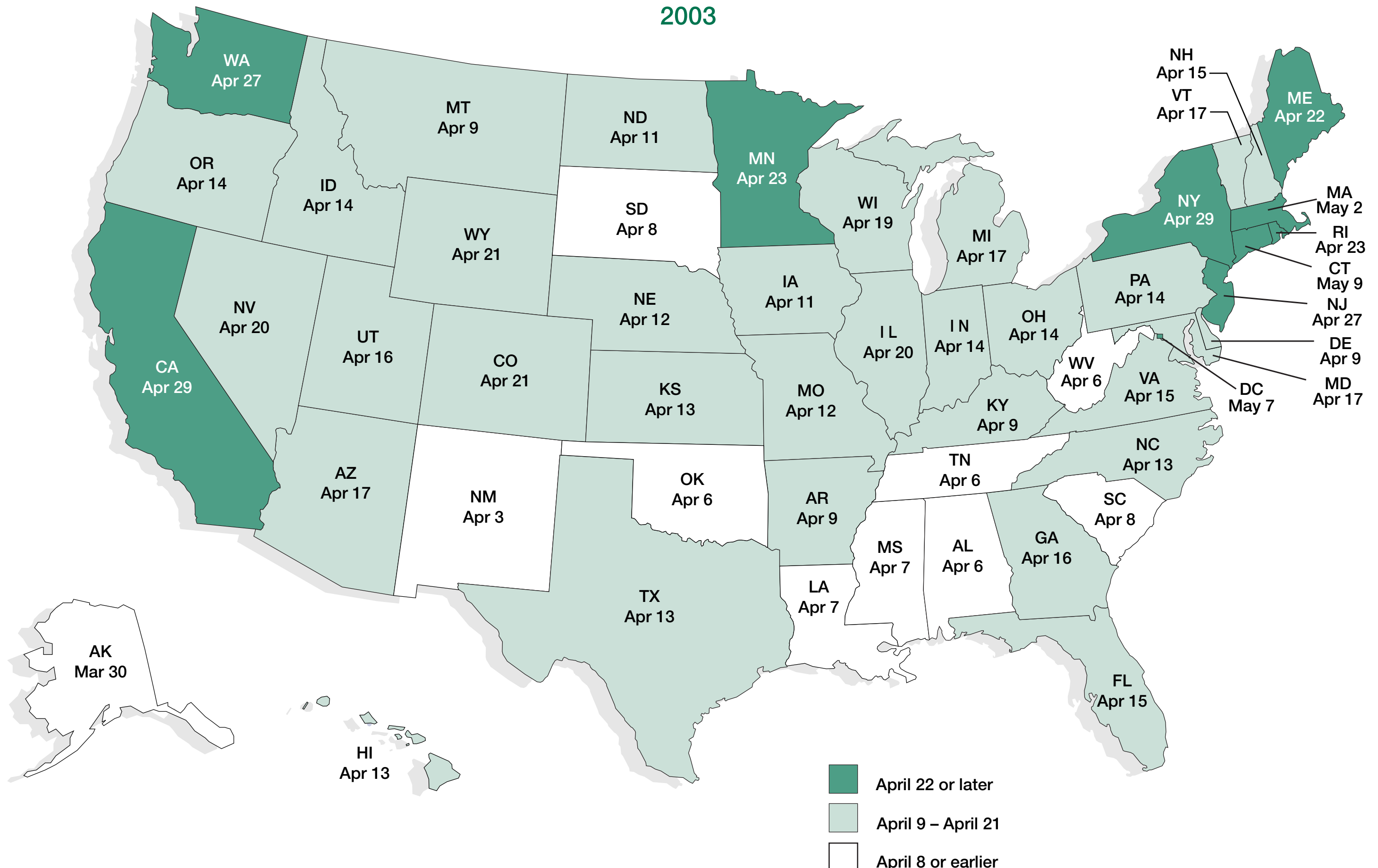
Outside Connecticut, residents of the Massachusetts (May 2), New York (April 29) and California (April 27) work the longest for taxes.

At the other end of the tax burden spectrum are states with comparatively early Tax Freedom Days. Alaska's is the earliest, March 30, and New Mexico is next with a Tax Freedom Day on April 3. Four states will celebrate Tax Freedom Day on April 6th: Alabama, Tennessee, Oklahoma and West Virginia.

State/Local Tax Burdens

To facilitate comparisons of state/local tax burdens, the Tax Foundation also presents each state's tax burden with federal taxes excluded. Thirty-four years of these state/local tax burden estimates are posted on the Foundation's web site: www.taxfoundation.org/statelocal70-03.html.

The nation's average state/local tax burden is 9.7 percent of residents' income, with the highest being Maine's 12.2 percent and the lowest being Alaska's 5.5 percent.



Nearly every state has seen its federal tax burden fall. The two contributing factors are the series of tax relief measures passed in 2001, 2002 and 2003; and the economic slowdown that has dragged on.

Meanwhile, the state and local tax burden has held steady for over a decade, hovering around 10 percent.

That doesn't mean state/local taxes haven't grown, just that they've grown at roughly the same rate as income. Clearly, until the current Administration in Washington, states have been far more responsive to constituent demands for tax relief than Congress and the President.

Secondly, states have relied somewhat less on notoriously volative income tax collections (37 percent of revenue vs. 52 percent at the federal level).

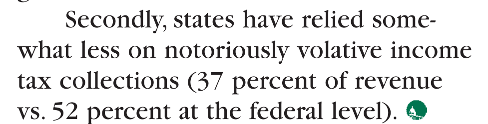


Table 1: Tax Freedom Day by State, by Rank

Calendar Year 2003

	Tax Freedom Day	Rank
Connecticut	May 9	1
Massachusetts	May 2	2
New York	April 29	3
California	April 29	4
New Jersey	April 27	5
Washington	April 27	6
Minnesota	April 23	7
Rhode Island	April 23	8
Maine	April 22	9
Wyoming	April 21	10
Colorado	April 21	11
Illinois	April 20	12
Nevada	April 20	13
Wisconsin	April 19	14
Vermont	April 17	15
Arizona	April 17	16
Maryland	April 17	17
Michigan	April 17	18
Georgia	April 16	19
Utah	April 16	20
Virginia	April 15	21
Florida	April 15	22
New Hampshire	April 15	23
Ohio	April 14	24
Idaho	April 14	25
Pennsylvania	April 14	26
Oregon	April 14	27
Indiana	April 14	28
Kansas	April 13	29
Texas	April 13	30
Hawaii	April 13	31
North Carolina	April 13	32
Nebraska	April 12	33
Missouri	April 12	34
Iowa	April 11	35
North Dakota	April 11	36
Montana	April 9	37
Kentucky	April 9	38
Delaware	April 9	39
Arkansas	April 9	40
South Carolina	April 8	41
South Dakota	April 8	42
Mississippi	April 7	43
Louisiana	April 7	44
West Virginia	April 6	45
Oklahoma	April 6	46
Tennessee	April 6	47
Alabama	April 6	48
New Mexico	April 3	49
Alaska	March 30	50
District of Columbia	May 7	-

Table 2: Days Spent Working for State-Local Taxes in Each State, State-Local Taxes as a Percentage of Income, Per Capita and Rank

Calendar Year 2003

	Tax Burden Rank	Days Spent Working to Pay Taxes	Tax Burden as a Percentage of Income	Tax Burden Per Capita	Income Per Capita
United States	-	35	9.7%	$ 3,150	$ 32,317
Alabama	45	30	8.4%	$ 2,194	$ 26,237
Alaska	50	20	5.5	1,830	33,018
Arizona	14	36	9.9	2,677	27,133
Arkansas	33	33	9.2	2,256	24,583
California	8	38	10.6	3,670	34,499
Colorado	32	33	9.3%	$ 3,219	$ 34,743
Connecticut	5	39	10.9	4,858	44,616
Delaware	48	26	7.3	2,502	34,439
Florida	44	30	8.4	2,586	30,803
Georgia	15	35	9.9	2,990	30,316
Hawaii	6	39	10.7%	$ 3,286	$ 30,691
Idaho	11	37	10.2	2,642	25,957
Illinois	30	34	9.4	3,288	34,939
Indiana	22	35	9.7	2,895	29,701
Iowa	26	34	9.5	2,799	29,338
Kansas	20	35	9.8%	$ 3,014	$ 30,909
Kentucky	31	34	9.4	2,516	26,738
Louisiana	28	34	9.5	2,512	26,578
Maine	1	44	12.2	3,519	28,960
Maryland	27	34	9.5	3,572	37,649
Massachusetts	13	36	9.9%	$ 4,105	$ 41,323
Michigan	29	34	9.4	2,989	31,673
Minnesota	3	40	11.0	3,888	35,247
Mississippi	24	35	9.6	2,251	23,421
Missouri	34	33	9.2	2,745	29,927
Montana	37	33	9.1%	$ 2,334	$ 25,651
Nebraska	16	35	9.8	3,094	31,480
Nevada	41	32	8.9	2,742	30,805
New Hampshire	49	24	6.6	2,396	36,418
New Jersey	19	35	9.8	3,993	40,936
New Mexico	21	35	9.7%	$ 2,428	$ 24,911
New York	2	43	12.0	4,534	37,819
North Carolina	25	34	9.5	2,766	28,977
North Dakota	17	35	9.8	2,765	28,129
Ohio	10	37	10.3	3,163	30,774
Oklahoma	35	33	9.1%	$ 2,441	$ 26,731
Oregon	39	32	9.0	2,682	29,874
Pennsylvania	36	33	9.1	3,024	33,152
Rhode Island	4	40	11.0	3,577	32,455
South Carolina	38	32	9.0	2,391	26,515
South Dakota	42	31	8.5%	$ 2,460	$ 28,903
Tennessee	47	28	7.7	2,241	28,912
Texas	46	30	8.3	2,492	29,906
Utah	9	38	10.6	2,699	25,372
Vermont	12	36	10.1	3,102	30,718
Virginia	40	32	8.9%	$ 3,064	$ 34,322
Washington	18	35	9.8	3,345	34,169
West Virginia	23	35	9.7	2,398	24,694
Wisconsin	7	38	10.7	3,341	31,323
Wyoming	43	30	8.5	2,733	32,256
District of Columbia	-	47	12.9%	$ 5,636	$ 43,529

FOUNDATION MESSAGE

Have the Stars Aligned for Tax Reform?

Scott A. Hodge
Executive Director
Tax Foundation

Despite the record number of tax cuts enacted over the past two years, I'm often asked, What is it going to take to get Washington to finally consider fundamental tax reform? While the primary ingredient for such a debate is presidential leadership, we will also need a confluence of events to motivate lawmakers to take on such a Herculean task.

That confluence of events could occur in just a few years when most of the tax cuts enacted in 2001 and 2003 are due to expire and Congress is simultaneously faced with the need to fix the Alternative Minimum Tax (AMT) before 30 million taxpayers are trapped in this parallel tax system.

When George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) into law on June 7, 2001, few Americans were aware that every provision within the $1.35 trillion tax bill was set to expire after December 31, 2010. The reason for this was that lawmakers were forced to adhere to an arcane but politically important Senate rule called the "Byrd Rule," named for Senator Robert C. Byrd (D-WV), who introduced it in 1985. In simple terms, the Byrd Rule says that any provision in a tax bill that permanently affects net federal receipts is subject to a "point of order" and can be struck from the bill. Since Republicans were unable to muster the 60 votes it takes in the Senate to waive a point of order, they chose instead to sunset all of the provisions in the bill after 2010.

If lawmakers do not make the 2001 Act permanent, millions of families will see a dramatic increase in their tax bills in 2011. Tax Foundation economists have estimated that the typical family of four will see their income tax bill increase by $2,222, or 42 percent, between 2010 and 2011.

As serious as the sunsetting of tax cuts is for families, it is most troubling for those seniors who must plan for passing their estates on to their children. The 2001 bill gradually phased out the estate tax between 2002 and 2009 and fully repealed the tax in 2010. But unless lawmakers make the repeal permanent, the tax will spring back to life in 2011, taxing estates at rates as high as 55 percent. Needless to say, this uncertainty has made estate planning impossible and led to dark jokes that children will hasten their parents' departure in 2010 before the old rates kick in.

The complexity spawned by the 2001 bill was made even worse when President Bush recently signed this year's $350 billion tax cut bill into law. This bill accelerates the phased-in tax cuts in the 2001 bill—including the reduction of marginal tax rates and the expansion of the child credit—into this year. However, to comply with the demands of a handful of Senators that the bill be no greater than $350 billion over ten years, lawmakers once again reverted to sunsets to make the bill appear less costly than it really is.

For example, the bill immediately expands the 15 percent tax bracket and increases the standard deduction for modest-income families impacted by the so-called marriage penalty. But in order to reduce the bill's overall "cost" to the U.S. Treasury, lawmakers will revert these provisions in 2005 to the phased-in schedule outlined in the 2001 Act"– effectively raising those families' taxes in 2005. Similarly, the bill's most significant features – cutting the tax rate on dividends and capital gains to 15 percent – are both temporary. Both sunset after December 31, 2008.

About the same time as lawmakers are forced to grapple with making these provisions permanent, millions of families will find themselves captured by the AMT. The AMT was enacted in 1969 after press reports revealed that a handful of wealthy taxpayers were avoiding paying income taxes through the use of aggressive tax shelters. The AMT is triggered when your deductions exceed a pre-set percentage of your income. The AMT limits the amount of deductions you can benefit from—including the home mortgage interest deduction, child credits and health care costs—and requires you to pay a fixed tax rate of 26 percent. It is especially punishing to families who live in high-tax states and areas with high property values.

Congress's Joint Committee on Taxation estimates that 2.2 million families will be hit by the AMT this year. If Congress fails to fix this punitive tax system, 30 million families could be affected by 2010 – roughly 1 out of every 5 taxpayers.

The collision of the need to fix the AMT and the need to make the 2001 and 2003 tax cuts permanent could be the spark that ignites a real debate over fundamental tax reform.

But a little publicized effect of the 2001 and 2003 tax cuts could undermine any efforts to overhaul the tax code. These bills were effective in knocking nearly 10 million taxpayers off the tax roles. Because these tax cut bills so generously expanded the child credit and the Earned Income Tax Credit (EITC), Tax Foundation economists estimate that nearly 40 million families will file a tax return this year but owe no income taxes, and many of these families will receive a "refund" check from the IRS even though they owe no taxes.

The case for fundamental tax reform is severely compromised when 30 percent of all taxpayers not only do not have a stake in the process, but could be harmed as a result. While most Americans fear and loathe the IRS, many of these 40 million taxpayers now look upon the IRS as a sugar daddy – dispensing generous refund checks.

The stars may be aligning for the cause of fundamental tax reform, but the widening gulf between those who bear the burden of income taxes and those who pay nothing threatens to make it a highly charged debate.

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Recent Tax Foundation Publications

Of three recent publications from the Tax Foundation, two appeared in the *Special Report* series, and one was a special handbook of state tax data.

The new handbook, *Facts & Figures: How Does Your State Compare?,* is pocket-sized but contains dozens of valuable state-by-state comparisons of tax rates and collections.

♦ Which state scores the best on the Tax Foundation's State Business Tax Climate Index?

♦ Which states have no income tax or no sales tax, or neither?

♦ Which states collect the least beer, gasoline or property taxes?

♦ Which states send the most money per capita to Washington?

♦ And of course, which state has the earliest Tax Freedom Day?

In March, we published our annual analysis of the President's Budget. It was No. 120 in the *Special Report* series, written by Chief Economist John Barry and titled, "The President's Fiscal 2004 Budget." It explains all the basics spending priorities of the President.

March's "State Tax Collections and Rates" by Economist David Hoffman was No. 121 in the *Special Report* series. It presents current tax rates and collection data, helping to answer the question, "Where should I live to lower my taxes?" All the tables from the report are posted in the state finance section of the Foundation's web site.

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The Foundation's mission sounds simple — to tell the truth about taxes to taxpayers, lawmakers and the media.

But considering how many people do not want the truth told, the job is always difficult, and it would be impossible without your generous support.

The Tax Foundation does not receive government funds, so we rely on you. Here are some ways that you can help:

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