

Tax Watch



Paying for Public Schools: What's the Cost of Judicial Mandates?

Message from
the President **2**

New Study:
Fixing AMT without
Raising Tax Rates **3**

Income Redistribution
between Young,
Middle-Aged, and Elderly **4**

Cigarette Taxes
Rising Fast **5**

Tax Foundation's
Media Impact **6**

Tax Foundation
Government Affairs;
State Tax Policy Impact **7**

Support the
Tax Foundation;
From the Archives: 1963 **8**

In the 1970s, education activists stumbled upon a new way of shoring up the budgets of America's declining public school system—court mandates that force lawmakers to spend more on education.

Since then education lawsuits have proliferated, with parents, teachers and school administrators arguing in state courts that legislatures have a constitutional duty to boost public education funding.

“Many people are aware of the growing number of court mandates for more education spending,” said Chris Atkins, Senior Tax Counsel at the Tax Foundation. “But until recently no one tried to carefully measure this cost to taxpayers or whether the lawsuits achieved their goal of boosting public school budgets.”

According to a new first-ever Tax Foundation study of education-finance lawsuits in America, there have been court mandates for public school spending in 27 of the 50 states since 1977. And the total cost to taxpayers? More than \$30 billion according to the study.

More Taxes, Less Learning

But while education lawsuits have raised taxes, the impact on school budgets is unclear.

The most surprising finding of the new study is that while lawsuits targeting “inequitable” or “inadequate” school funding boost education spending in the short run, they’ve mostly failed to achieve their goal of higher school spending in the long run.

“Lawsuits may be able to build schools, but they haven’t proven effective at teaching kids,” said Atkins, author of the new Tax Foundation study.

“Higher state and local tax burdens appear to be the only enduring result of school finance lawsuits. This research questions the conventional wisdom that you can sue your way to a better school.”

The new study—titled “Appropriation by Litigation: Estimating the Cost of Judicial Mandates for State and Local Education Spending”—chronicles the

impact of court mandates on education spending and taxes in 27 of the 50 states.

According to the study, court involvement in school finance had its genesis in the civil rights movement of the 1960s. At that time, litigants desired the noble goal of enhanced educational opportunity for school children regardless of race, wealth, or location.





TaxWatch

Tax Watch (ISSN 1552-924X) is published six times per year by the Tax Foundation in Washington, D.C., a nonprofit, non-partisan research organization that has monitored tax policy at the federal, state and local levels since 1937.



The Tax Foundation is a 501(c)(3) nonprofit organization that relies on tax-deductible contributions for support. Annual subscriptions are \$30. Please send correspondence to:

Tax Watch
2001 L Street N.W., Suite 1050
Washington, DC 20036

Visit us on the web at www.taxfoundation.org or call (202) 464-6200.

© 2007 Tax Foundation

Message from the President: U.S. Corporate Taxes Still Among World's Most Punitive



Treasury Secretary Henry Paulson's call this summer for a lower corporate tax rate to boost U.S. competitiveness sparked hopes that America will be the next to catch the global wave toward lower corporate taxes. And just in time. The case for dropping America's corporate tax rate to match trends in other OECD countries has never been stronger.

In 2006 alone, five countries cut their corporate income tax rates. And eight more, including Germany, will have cut their rates by January 1, 2008.

As OECD countries continue dropping corporate tax rates they can expect to reap more foreign direct investment from the U.S. One recent study by economists Michael Devereux and Ben Lockwood found that when an EU member state cuts its corporate rate by 10 percent—from 30 percent to 27 percent for example—it can expect to reap a 60-percent short-run increase in investment by U.S. multinational corporations.

While foreign governments are attracting U.S. investors by cutting corporate taxes, the federal government in the U.S. has kept our punitive and inefficient rate structure steady for 12 years. That makes the U.S. one of only two countries in the OECD not to cut its corporate tax rate between 1994 to 2006, and one of only six countries without a rate cut between 2000 and 2006.

It's clear that the U.S. needs a new policy on corporate tax competitiveness. And with corporate tax rates dropping like a rock in competing OECD countries, the need for a new policy becomes more pressing with each passing year.

Today only Japan taxes corporate income at a higher rate than the U.S. However, Japan did cut its rate recently. Today, Japan's 39.5 percent rate is just barely above our 39.3 percent rate.

Since 2000, not one OECD country has raised its corporate tax rate. The average cut was 15.5 percent, from an average of 33.7 percent to 28.5 percent. Just since last year, five more countries (Czech Republic, France, Greece, Mexico, and the Netherlands) cut their corporate tax rates.

And the trend continues in 2007. Seven countries cut their corporate tax rates this year, with Turkey leading the way with a 33 percent rate reduction. Germany will again cut its corporate rate on January 1, 2008. France, Japan, and the United Kingdom may also reduce their rates in the next year.

If the high U.S. tax rate generated large revenues, it would make sense for Congress to oppose rate cuts. But that's not the case. The U.S. Treasury collects far less revenue as a percentage of GDP than many countries with lower rates.

So what should Congress do? One option is to aim for a combined U.S. tax rate in the range of 20 percent to 25 percent. Not only would that cut the U.S. tax rate to the OECD average, it would help restore America's stature as a beacon for good tax policy around the world.

Sincerely,

Scott A. Hodge

New Study: Fixing AMT without Raising Tax Rates

Trimming back the Alternative Minimum Tax (AMT) has been a hot issue in Congress lately. Unfortunately, most plans to scale back the AMT do so by hiking other taxes. But a new Tax Foundation study shows there's a better way to fix the AMT that would also cut taxes for millions of Americans.

The new study presents a revenue-neutral plan to fix the Alternative Minimum Tax that restores it to its original, limited role of preventing a few high-income people from combining so many deductions and exemptions that they owe little or nothing. But at the same time the plan cuts tax rates for low- and middle-income groups.

“Under the Tax Foundation plan, the majority of tax returns in every income group less than \$500,000 would get a tax cut,” said economist Gerald Prante, author of the new study.

The plan calls for four tax-cutting provisions and four expansions of taxable income that offset each other, keeping revenue the same. The plan's tax cuts include the following:

- Raise the AMT exemptions to \$300,000 for singles and \$450,000 for couples and index them for inflation;
- Drop the 10 percent rate to 8.5 percent;
- Drop the 15 percent rate to 13.5 percent;
- Drop the 25 percent rate to 24 percent.

To pay for those tax cuts, the plan broadens out the federal income tax base and scales back special tax preferences that lawmakers use to reward certain taxpayer behaviors and punish others. The plan would repeal the federal deductions for state and local income taxes, sales taxes, real estate taxes and municipal bond interest.

A Better Way Forward

Some in Congress have called for a straightforward repeal of the AMT, but new House rules requiring a pay-as-you-go, revenue-neutral approach to tax changes make straight repeal unlikely.

“Other plans to fix the growing AMT raise tax rates dramatically,” said Prante. “And some even dredge up a bad idea from Vietnam War days—special income surtaxes.”

The Tax Foundation plan is superior from an economist's standpoint because so few tax returns would face higher marginal effective tax rates.

“Broadening the tax base is an essential part of good tax policy,” said Prante. “Plans that make up for lost AMT revenue by raising rates instead of broadening the base will do more damage to the economy.”

High-income, high-tax states are likely to object to the loss of the state-local tax deduction. But as the new study explains, they will gain the most from the plan's higher AMT exemption levels.

“We view this AMT fix not as the fundamental tax reform the nation needs, but rather as a bridge to 2011 when the Bush tax cuts expire,” said Scott A. Hodge, President of the Tax Foundation. “By that time, we will hopefully have designed a more far-reaching tax reform that would build on the theme of this AMT fix—broadening America's tax base to allow broad-based cuts in overall tax rates.”

Read the full study, “A Progressive AMT Fix Without Higher Tax Rates,” online at www.taxfoundation.org.



“A new Tax Foundation study shows there's a better way to fix the AMT that would also cut taxes for millions of Americans.”

Tax Fact:

Percentage of tax filers who don't use any federal income tax deductions: 64 percent.

Study Finds Income Redistribution between Young, Middle-Age and Elderly

“As the Baby Boom generation prepares to retire, lawmakers should be aware of the distribution of taxes and government spending across age groups.”

Between \$376 billion and \$872 billion per year is redistributed from middle-aged groups to the youngest and oldest Americans each year through government taxes and spending, according to a new Tax Foundation study of taxing and spending by age groups.

America’s youngest households, those headed by someone 25 or less, receive \$2.32 in government spending for each dollar of taxes paid, and America’s oldest households aged 75 and over receive \$4.93 per dollar of taxes paid. Meanwhile, in the middle, households aged 45 to 54 received 73 cents per tax dollar.

“As the Baby Boom generation prepares to retire, lawmakers should be aware of the distribution of taxes and government spending across age groups,” said Scott A. Hodge, President of the Tax Foundation.

Middle-Age Pay Highest Taxes

Over a lifetime, government spending follows a U-shaped pattern, with large education and welfare spending in youth and large Social Security and Medicare payments in old age.

Spending on the elderly is largely in the form of transfer payments, transferred through such famous programs as Social Security, Medicare and Medicaid. Other transfer payments include welfare, farm payments, unemployment insurance and the refundable portion of the Earned Income Tax Credit (EITC). In 2004 government spending on transfer payments was about \$13,000 per household, or 42 percent of all government spending.

Young households receive most government spending in the category of “private goods,” things that aren’t cash payments but are still supplied directly to identifiable households. These include spending on roads, airports, public schools, police and fire protection, parks, energy, and mass transportation. These added up to about \$9,960 per

household in 2004, or about 32 percent of overall government spending.

“Public goods” made up the rest. These spending programs are not targeted at certain people but at the entire population—such classic government functions as national defense, environmental protection, criminal justice and so on. In 2004, total spending on public goods was \$8,150 per household, or about 26 percent of total government spending.

The study highlights the fact that America as a nation is getting older. In 1990, the median age of the American population was 32.8. By 2005 it had risen to 36.4. And because old-age income support programs such as Social Security and Medicare make up a large portion of the federal budget, an aging America means higher tax bills for Americans in their working years.

“Currently, federal spending for old-age entitlement programs is on an unsustainable path due to the growing number of elderly Americans collecting federal transfer payments and the shrinking pool of workers available to pay payroll taxes,” said economist Gerald Prante, co-author of the new study.

“As the 78 million Americans in the Baby Boom generation move into retirement in the coming decades,” said Prante, “the disparities between taxes and spending across age groups highlighted in this report are likely to grow.”

Read the full study, “Generational Equity: Which Age Groups Pay More Tax, and Which Receive More Government Spending?”, online at www.taxfoundation.org.



America's Poor Tax: Cigarette Taxes Rising Fast

It's well known that cigarette taxes fall hardest on the poor. But that hasn't derailed lawmakers' efforts to ratchet up smoke taxes in recent years.

According to two new Tax Foundation studies, America's cigarette taxes are rising even faster than property taxes. And thanks to an effort in Congress to raise the federal cigarette tax to pay for children's health insurance, that trend is likely to continue.

Poor Pay the Most

This summer, the Senate debated whether to raise \$35 billion in new cigarette tax revenue to boost a low-income health program known as the State Children's Health Insurance Program (SCHIP).

Because the plan was aimed at helping poor families, Tax Foundation economist Gerald Prante compared the use of cigarette taxes to six other federal taxes. Among the seven taxes, cigarette taxes were hardest on the poor, defeating the

purpose of the plan.

"The burden of the proposed cigarette tax hike on the lowest-earning 20 percent of households is 37 times heavier than it would be if the government raised the money with the federal income tax," said Prante.

According to the study, the proposed cigarette tax hike would hit the poor with the same force as cutting the Earned Income Tax Credit (EITC)—a federal low-income-support program—by one quarter.

Rising Fast

According to another Tax Foundation study, the anti-poor nature of cigarette taxes hasn't reduced their popularity with lawmakers.

Tax Foundation economist Curtis Dubay explored the argument made by some that the tobacco tax has been dormant for so long that it is overdue for a raise.

"It's a myth that cigarette taxes haven't been rising in recent years," said Dubay. "The federal cigarette tax may have stayed at 39 cents for five years, but 36 of the 50 states have raised cigarette taxes since 2002."

That tax-hiking trend has not slowed in 2007. Five states have already enacted higher cigarette taxes this year.

According to the study, since 2002 the average state-level cigarette tax has jumped from 67 cents per pack to \$1.03. Including federal taxes, the average tax per pack jumped from \$1.06 in 2002 to \$1.42 today.

"That's a 34-percent increase, more than double the rate of inflation," said Dubay. "That impeaches any argument that cigarette taxes have somehow lost their bite in recent years."

Looking at total tobacco tax collections rather than tax rates, in the five-year period from 2000 through 2005 tobacco tax collections rose 45 percent according to the Department of Commerce's Bureau of Economic Analysis.

"Not even property taxes have grown as fast as cigarette taxes, despite a housing bubble that pushed property taxes up at a historically rapid pace," said Prante.

So why are cigarette taxes on the rise? According to Prante, it's a classic case of majority politics.

"Smokers are a minority, about 20 percent of the population nationwide," said Prante. "Politicians have identified an unpopular minority and are forcing punitive taxes on them."

Read the full studies, "State Tobacco Tax Rates Have Skyrocketed Since Last Federal Tax Increase" and "Options for Funding SCHIP Expansion: Cigarette Taxes Least Defensible Alternative," online at www.taxfoundation.org.

Tax Fact:

Federal public school funding per student in 1999: \$578. Today: \$919



"Smokers are an unpopular minority, and lawmakers are forcing punitive taxes on them."

*Education Lawsuits
(continued from
page 1)*

*“Since 1977,
twenty-seven
states have spent
\$34 billion on
public schools
to comply with
judicial orders.”*

In the late 1960s, two academic studies gave plaintiffs the ammunition they needed to launch school finance lawsuits. They argued that school systems that based school spending on anything other than the wealth of the state as a whole violated due process. With that legal groundwork in place, education lawsuits proliferated.

According to the study, since 1977 lawmakers in 27 states have appropriated roughly \$34 billion to public schools to comply with judicial orders. That works out to about \$1,000 per pupil, or more than 10 percent of per-pupil spending in those states.

The study reveals judges in some states are more willing to demand school spending than in others. Court cases in New York and New Jersey account for more than half the total. In those states, courts required lawmakers to approve \$10 billion and \$8 billion in additional school spending, respectively.

Courts in Ohio and Texas have been active as well, each forcing lawmakers to approve roughly \$2 billion in spending. Courts in three other states have required additional public school spending of over \$1 billion.

Where the Money Goes

Legislative responses to court mandates have varied. Sometimes they boost funding for higher teacher salaries, buildings

or new computers, and other times they take the form of general grants that aim to equalize funding across school districts.

“Courts are clearly having a fiscal impact on state budgets in the short-term, where mandates are forcing lawmakers to immediately increase state spending on education,” said Atkins.

But in the long-term the impact of the lawsuits is different. Despite spending hikes to comply with court mandates, 18 of the 27 states examined in the study spent \$284 less per pupil in 2004 than they would have been expected to based on growth trends before the court mandates.

Especially in states where courts forced lawmakers to increase recurring expenditures like teacher salaries, the new Tax Foundation study suggests that appropriation by litigation is not an effective way to secure more permanent funding for public schools.

“Our findings show that while judges certainly hold power, the legislature will always retain the ‘power of the purse,’” said Atkins. “In the long run, the best way to fund schools is not to demand money from the courts. It’s to convince legislatures that it’s a good use of taxpayer dollars.”

Read the full study, “Appropriation by Litigation: Estimating the Cost of Judicial Mandates for State and Local Education Spending,” online at www.taxfoundation.org.



Tax Foundation's Media Impact

This summer has seen the Tax Foundation's work highlighted in major media outlets throughout the 50 states. So far this year we've been cited hundreds of times in newspapers from coast to coast, as well as by television, radio and internet sources. Here's a brief sampling of our most recent hits:

Television

President Scott Hodge appeared on CNBC to discuss America's competitive disadvantage in the global economy thanks to our sky-high corporate tax rates.

Radio

Our economists have been spreading the message of sound tax policy on America's airwaves, including WTOP Washington, KPOO San Francisco, KCUB Tucson, WBUR Boston, WILK Scranton, WSKY Gainesville, Wisconsin Public Radio and others.

Print Media

Tax Foundation research made news this summer in the *Wall Street Journal*, *Atlanta Journal-Constitution*, *Springfield News-Leader*, *New York Sun*, *Washington Times*, *Baltimore Sun*, *Salt Lake Tribune*, *Detroit News*, *The Hill*, *Fort Worth Star-Telegram* and many more.

Learn more about the Tax Foundation's media impact at www.taxfoundation.org/press/.

Tax Foundation Government Affairs: Turning Ideas into Good Policy



The Tax Foundation continued to expand its ambitious government affairs program this summer, most notably with the addition of Tonya Barr as the Manager of State Relations, to complement the work Megan Carpentier is doing in Congress. As we continue reaching out to federal lawmakers in Washington, the addition of Ms. Barr assures that our economists' research will reach policymakers at the state and local levels as well.

Here's a brief summary of our recent government relations efforts:

- Hosted a Washington, D.C. panel discussion on "The State and Local Tax Deduction: Solution, or the Problem?" for Congressional staff, featuring Tax Foundation President Scott A. Hodge and economists from the Urban Institute and the American Enterprise Institute.
- Developed a weekly email to Congressional staff highlighting timely Tax Foundation research, including a toolkit of resources on the Alternative Minimum Tax and research comparing U.S. tax rates to other OECD countries.
- Hosted events at the annual meetings of the American Legislative Exchange Council and the National Conference of State Legislatures to talk about Tax Foundation research, including the popular State Business Tax Climate Index. Tax Foundation booths at both these meetings were stocked with publications and staffed by our economists and staff, drawing visits by hundreds of lawmakers.

Learn more about government affairs at the Tax Foundation at www.taxfoundation.org/legislation/.

Bringing Sound Tax Policy to the States

In addition to producing a steady stream of publications, the Tax Foundation's state policy team has been working at the ground level in Philadelphia, Boston, Michigan and Mississippi, impacting tax policy in the states. Here's a brief summary:

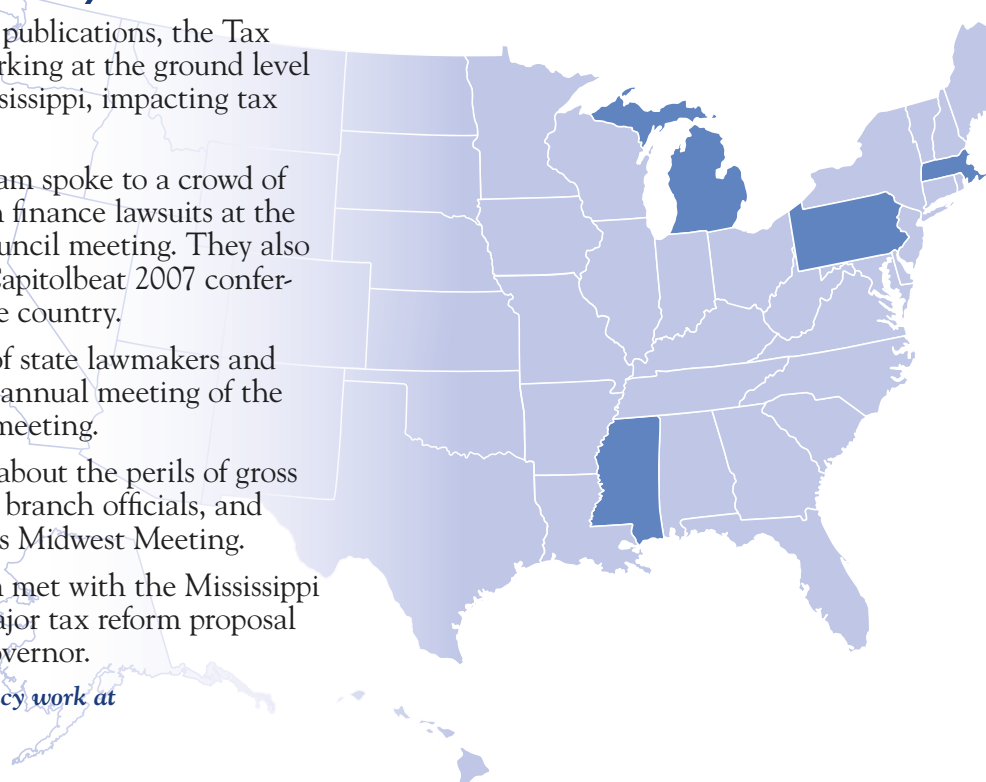
Philadelphia: The Tax Foundation state team spoke to a crowd of state lawmakers about the cost of education finance lawsuits at the annual American Legislative Exchange Council meeting. They also spoke about state tax policy trends at the Capitolbeat 2007 conference, attended by reporters from around the country.

Boston: Our economists met with dozens of state lawmakers and hosted a panel on state tax rankings at the annual meeting of the National Conference of State Legislatures meeting.

Michigan: In August the state team spoke about the perils of gross receipts taxes to state lawmakers, executive branch officials, and judges at the Council of State Governments Midwest Meeting.

Mississippi: Also in August, the state team met with the Mississippi Center for Public Policy to help design a major tax reform proposal that will be presented to the Mississippi Governor.

Learn more about the Tax Foundation's state policy work at www.taxfoundation.org/research/topic/9.html.



Support the Tax Foundation



Since 1937, the Tax Foundation has monitored America's tax policies, and our research and educational efforts on the economic impact of government policy have stood the test of time. Our annual calculation of Tax Freedom Day® remains one of the most widely used tools for illustrating America's tax burden to media professionals, legislators, and—most importantly—taxpayers. None of this work would be possible without the

generosity of our supporters. By making a tax-deductible investment in the Tax Foundation, you become a valuable partner in helping to assure that our research and publications continue to shape sound tax policy in America—for the good of future generations of taxpayers, as well as our own.

Please use the enclosed envelope to send your contribution today, or visit our website at www.taxfoundation.org to make an online contribution.

For more information about supporting the Tax Foundation, contact Lisa Hazlett at (202) 464-5110 or hazlett@taxfoundation.org.

By making a tax-deductible investment in the Tax Foundation, you become a valuable partner in helping to assure that our research and publications continue to shape sound tax policy in America.

From the Archives: 1963

A Little of Each, Please

*ESTIMATED PER CAPITA FIGURES

TAX FOUNDATION

Taxes collected (excluding social insurance) by Federal, state and local governments reached an all-time high, \$123 billion (est.) in fiscal 1962. This is the equivalent of \$664 for every American, about \$100 higher than in fiscal 1959. The per person size of the tax burden by tax category is shown above.