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Taxpayers, Beware: Record Tax Burden Is Rising

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Congress is threatening to raise taxes significantly and often as it debates a variety of major tax and spending proposals. But before Congress launches into a new spate of tax hikes, policymakers and taxpayers need to understand the historical context of overall tax levels and where those levels are headed under current policy. Although federal taxes as a share of the overall economy have stayed relatively constant over the past 40 years, the amount paid by individual taxpayers hits a new record almost every year even after adjusting for inflation. Rather than continuing this trend, Congress should be looking to cut taxes and spending.

Tax Levels and the Tax Share. The simplest perspective on tax policy is the amount of tax money collected and the rate at which this collection is expected to increase. Federal receipts are forecast to reach $2.577 trillion in 2007, and are expected to grow by 5.1 percent in 2008 and by almost 4 percent per year over the next five years. These forecasts for solid revenue growth reflect the assumptions that the 2001 and 2003 tax cuts are extended through that period, that provisions such as the Research & Development tax credit are extended, and that the Alternative Minimum Tax (AMT) "patch" is indexed and extended.[1]

The level and rate of growth of collections is useful in terms of cash flow, but it provides little help to policymakers and taxpayers in revealing whether taxes are, in some meaningful sense, high or low, or rising or falling. To address these issues, the raw data must be given some relevant context.

A common and useful measure for providing context to tax policy is the tax share—the ratio of taxes collected to the level of economic activity.[2] The federal tax share in 2007 is expected to be about 18.8 percent of gross domestic product (GDP), just above its 40-year average of 18.3 percent. The federal tax share has ranged in a surprisingly narrow band over this period, between 17.5 percent and 20 percent, suggesting relatively little net change despite numerous economic and policy swings.

Tax Levels from the Taxpayers' Perspective. The tax share measures the level of resources extracted by the federal government from the private economy. At best, however, it is a partial display of the level of taxation, because it fails to associate taxpayers with the taxes paid. A very different picture emerges when the level of tax collections is examined from the taxpayers' perspective.

An important concept in tax policy is that "businesses don't pay taxes; people pay taxes." A business, whether a corporation, partnership, or sole proprietorship, is a legal and financial extension of its owners. It is a tool for organizing economic activities and a conduit for financial flows. A business may report a profit or a loss, but it is the owner or owners who earn the profit or incur the loss. Simi-

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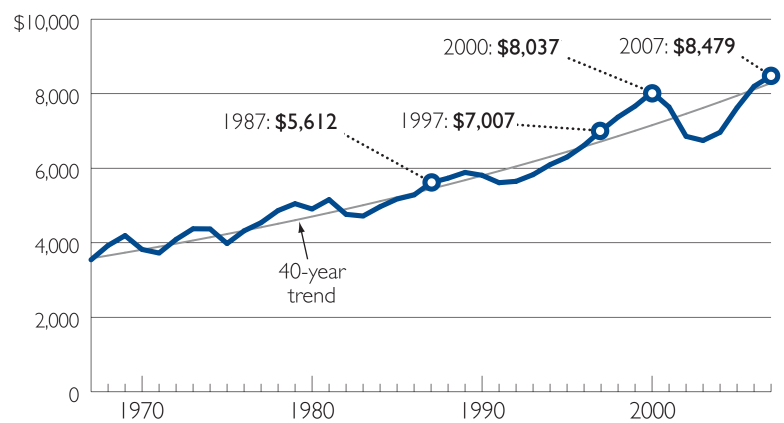
larly, the business remits tax to the Internal Revenue Service, but the tax levy is ultimately subtracted not from the capital of the *business* but from the income and capital of the *owners*, or in some cases its workers or customers. Wherever the tax burden ultimately falls, it falls on some person or group of people, not on the business itself.

In like manner, economies don't pay taxes; taxpayers pay taxes. From the taxpayers' perspective, a more pertinent presentation of tax policy is the amount of taxes paid per individual—the American taxpayer burden. In 2006, the per capita federal tax burden was $8,197—up $574 in inflation-adjusted dollars since 2005. In constant dollars, the 2006 burden was $160 higher than the previous all-time record set in 2000.[3]

Chart 1 WM1639

Real Per Capita Federal Tax Burden



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts.

A simple example demonstrates the difference between the tax share and the taxpayer burden and why the latter is, in important respects, the better measure of the resources demanded of the governed by the government. In 2007, the taxpayer burden is projected to be more than $8,400 per person, while the tax share is projected to be 18.8 percent of GDP. Suppose both GDP and federal taxes double over the next 20 years after adjusting for inflation. To keep the calculations simple, suppose as well that the size of the population is unchanged over that period.

Table 1 WM1639

The Rising Burden of Government: A Hypothetical Example
(in 2007 dollars)

	GDP	Tax Share	Per-Capita Tax Burden
Today	$13.9 trillion	18.8 percent	$8,400
2027	$27.8 trillion	18.8 percent	$16,800

Source: Heritage Foundation calculations.

In this case, the tax share would remain at 18.8 percent of GDP, suggesting the effective level of taxes was unchanged. However, the real per capita tax burden would have doubled to more than $16,800. Per person and after inflation, Americans would be paying for twice as much government as they do today, yet the tax share would suggest that nothing changed.

As shown in Chart 1, the taxpayer burden has risen at a remarkable pace over the past 40 years as the federal government's appetite for spending on a

1. Forecasts reflect latest baseline forecast from the Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2007, as well as earlier CBO forecasts of specific tax provisions in "An Analysis of the President's Budgetary Proposals for Fiscal Year 2008," March 2007, and Heritage Foundation calculations.
2. For a discussion of the federal and total national tax share, see JD Foster, Ph.D., "Rising State and Local Tax Burden Crowds Federal Tax Policy," Heritage Foundation *WebMemo* No. 1628, September 21, 2007, at *www.heritage.org/Research/Taxes/wm1628.cfm*.
3. This comparison is based on inflation-adjusted dollars relative to 2007 price levels using the personal consumption expenditure price index.

per capita basis has soared. Even after adjusting for inflation, the taxpayer burden rose from $6,614 in 1996 to $8,197 in 2006—an increase of 24 percent over 10 years despite the 2001 and 2003 tax cuts. Taxpayers on average are actually paying twice as much in taxes as they were 35 years ago.

The chart also shows the remarkable consistency in the growth of the taxpayer burden year after year. Over the past 40 years, the taxpayer burden has risen at an average rate of just over 2.1 percent per year. Even after the 2001 and 2003 tax cuts, the tax burden rapidly returned to its historical growth rate. Americans are right to perceive a growing tax burden despite the calming appearances of the traditional tax-to-GDP ratio. The individual federal tax burden has risen rapidly and steadily.

Source of the Rising Taxpayer Burden. Numerous factors contribute to the rising taxpayer burden. Changes in tax policy can obviously have an effect. Tax policy has seen many significant changes over the past 20 years, including two large tax hikes in the early 1990s, a modest tax cut in 1997, and major tax relief in 2001 and 2003.

Until relatively recently, inflation was another important factor. Much of the federal income tax is indexed for inflation, with a few notable exceptions such as the Alternative Minimum Tax exemption amount. Adjusting for inflation protects taxpayers from being pushed into ever-higher income tax brackets as their incomes rise to keep pace with inflation. Inflation indexing, first introduced systematically with the Reagan tax cut in 1981, was a tremendous advance for tax policy and for taxpayers.

A third factor in the growth of the taxpayer burden is gains in wages after adjusting for inflation. Over time, workers tend to capture the benefits of steadily higher labor productivity through rising real wages. However, real wage growth pushes taxpayers into higher tax brackets bearing higher marginal tax rates, so the per capita tax burden tends to increase as long as labor productivity is rising.

Real wage and salary income over the past 40 years has averaged almost 2.9 percent annual growth.[4] This exceeds the 2.1 percent annual growth rate in the taxpayer burden, suggesting that other changes, possibly including changes in tax policy on net, have slowed the growth in the tax burden. Even with inflation indexing, and even if Congress extends all the existing tax relief and takes a pass on enacting new tax hikes, the taxpayer burden will continue to rise year after year with increasing real wages unless Congress enacts additional tax relief.

Conclusion. The federal government's appetite for tax revenues appears to know no bounds. Congress has a long list of tax hikes under consideration to pay for new spending. Yet the American taxpayer is already subject to a historically high and rapidly rising level of federal taxes, even when accounting for the 2001 and 2003 tax cuts. While the federal tax share is now just above its 40-year average, the taxes paid per individual hits a new record almost every year, even after adjusting for the effects of inflation. Rather than raising taxes, Congress should be looking to cut taxes. A first benchmark of their progress would be to freeze the taxpayer burden at the 2007 level.

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4. This calculation is based on total wage and salary disbursements reported in the National Income and Product Accounts, adjusted for inflation using the personal consumption expenditure deflator.