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March 10, 2008

HAVE THE 2001 AND 2003 TAX CUTS MADE THE TAX CODE MORE PROGRESSIVE?

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Summary

Supporters of extending the 2001 and 2003 tax cuts claim that these tax cuts' benefits have been broadly and fairly distributed. Some argue that the tax cuts have actually made the tax system more progressive, pointing to Congressional Budget Office (CBO) data showing that the share of total federal income taxes paid by the top 1 percent of households rose modestly after the tax cuts were enacted.

The claim that the tax cuts are fairly distributed and have made the tax code more progressive does not withstand scrutiny. Whether measured in dollar terms or as a share of household income, the tax cuts going to high-income households are much larger than those going to all other households.

- When fully in effect, the tax cuts will boost after-tax income by more than 7 percent among households with incomes of more than $1 million, but just 2 percent among middle-income families, according to Urban Institute-Brookings Institution Tax Policy Center estimates. A progressive tax cut, like a progressive tax system, is one that reduces inequality. But, as these data show, the tax cuts enacted in 2001 and 2003 are *widening* the gap in after-tax incomes, which was historically large even before the tax cuts were enacted.

- In 2010, when the tax cuts are fully in effect, the average household earning more than $1 million a year will receive $158,000 in tax cuts, according to the Tax Policy Center; the average middle-income household will receive $810.

- The same CBO data cited by the tax cuts' supporters show that the top 1 percent of households pay almost 5 percent less of their income in federal personal income taxes than they did in 2000, before the tax cuts. No other group got a tax cut nearly as large.

The CBO finding cited by the tax cuts' supporters does not change these facts. High-income households now pay a modestly larger share of federal income taxes *not* because the tax cuts are somehow tilted against them — to the contrary, the tax cuts are tilted decisively in their favor — but instead because (1) their incomes have risen much faster than other households,' and (2) the tax cuts have significantly shrunk the total revenue "pie."

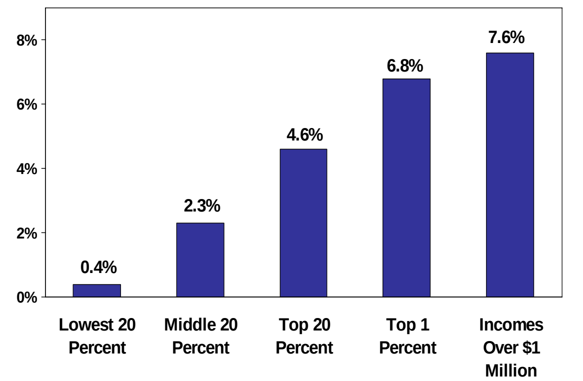
The Tax Cuts Widened Income Gaps

A progressive tax code is one that makes the distribution of *after*-tax income more equal than the distribution of *pre*-tax income. (This definition is accepted by analysts across the political spectrum.) Hence, one tax code is "more progressive" than another if it has a larger effect in reducing income inequality. For the 2001 and 2003 tax cuts to have made the tax code more progressive, after-tax incomes would have to be less unequal today than if the tax cuts had not occurred. In fact, the tax cuts have made the distribution of after-tax income *more* unequal.

FIGURE 1

Recent Tax Cuts Have Been Regressive

Percent Increase in After-Tax Income From 2001 & 2003 Tax Cuts When Tax Cuts Are Fully in Effect



Source: Urban Institute-Brookings Institution Tax Policy Center

When fully in effect, the 2001 and 2003 tax cuts will increase the incomes of high-income households by a much larger percentage than the incomes of low- or middle-income households, according to estimates by the Tax Policy Center. As Figure 1 shows, the tax cuts will increase the after-tax incomes of households with annual incomes above $1 million by an average of 7.6 percent, compared to a 2.3 percent increase for households in the middle of the income spectrum and a 0.4 percent increase for the lowest-income 20 percent of households. This means that *high-income households will hold a larger share of the nation's after-tax income as a result of the tax cuts*, which makes the tax cuts regressive, not progressive.

Similarly, the same CBO data cited by tax-cut supporters show that:

- High-income households are paying considerably less of their income in income taxes now than before the tax cuts. In 2000, households in the top 1 percent of the income scale paid an average of 24.2 percent of their income in federal income taxes. By 2005 (the latest year for which data are available), that figure had fallen to 19.4 percent, the lowest level since 1986.

Table 1: Drop in Income Tax Burdens for Various Groups, 2000-2005

Income Group	Drop in Effective Federal Individual Income Tax Rate (Percentage Points)
Lowest 20 percent	-1.9%
Middle 20 percent	-2.0%
Top 20 percent	-3.4%
Top 1 Percent	-4.8%

Source: Congressional Budget Office

- Income tax burdens, measured as a share of income, fell considerably more for high-income households than for other households. (See Table 1.) While effective federal income tax rates dropped by 4.6 percentage points for those in the top 1 percent of the income scale, they fell by about 2 percentage points for middle- and low-income households.[1]

[1] It should be noted that the Tax Policy Center estimates provide a better guide to the effects of the tax changes enacted in 2001 and 2003 than the CBO data do. The CBO data reflect the effects not only of legislative changes but also of changes in the economy and in the distribution of pre-tax income. In addition, the CBO data may understate the regressivity of the tax cuts relative to what it will be when all of the tax cuts are fully in effect, since some income tax

Claim That the Tax Cuts Were Progressive Relies on a Flawed Measure

The CBO data do show that the top 1 percent of households paid a modestly larger share of federal income taxes in 2005 than in 2000. But the change in the share of taxes paid is not a useful metric for assessing which income groups benefited the most from the tax cuts or whether the tax cuts made the tax code more or less progressive.

First, this measure is distorted by growing inequality in pre-tax incomes. When high-income households' share of pre-tax income in the nation increases — as it did between 2000 and 2005 — the share of total taxes that these households pay naturally rises as well, for reasons having nothing to do with legislated changes in tax policy. That is, high-income households are paying a larger share of taxes in part because they now have a larger share of the nation's income.

More fundamentally, the "share of taxes paid" measure is uninformative because it does not measure how tax cuts affect the distribution of income, the key question for assessing progressivity. All it captures is how households' tax cuts compare to their pre-tax-cut income tax liabilities. Because low- and middle-income households had relatively low federal income tax liabilities before the tax cuts, even the relatively modest tax cuts they received reduced their tax liability by a considerable percentage. High-income households, in contrast, had significantly higher income tax liabilities before the tax cuts, so their far *larger* tax cuts reduced their income tax liabilities by a *smaller* percentage. As a result, high-income households pay a modestly larger share of total federal income taxes, even though they also got the biggest tax cuts and ended up with a larger share of the nation's after-tax income. (For a simplified example showing how this can occur, see the box on page 4.)

Specifically, the Tax Policy Center estimates that without the tax cuts, households in the middle fifth of the income scale would have owed a little more than 5 percent of their income, or about \$2,200 on average, in federal income taxes in 2010. (They would have paid considerably more than \$2,200 in payroll taxes.) Since these households will receive tax cuts averaging about \$800 in 2010 — or about 2 percent of their income — the tax cuts reduce their federal income tax liability by a little more than a third.

Meanwhile, households in the top 1 percent would have owed about 23 percent of their income, or about \$320,000 on average, in federal income taxes without the tax cuts. (This group has average income before taxes of about \$1.4 million.) For their tax cuts to have been the same size, measured as a share of income tax liability, as the tax cuts going to middle-income households — i.e., to have kept their share of taxes paid from increasing — the top 1 percent would have had to receive about tax cuts averaging about \$110,000 apiece in individual income tax cuts. Instead, they will get individual income tax cuts of "only" about \$55,000 on average, or about 4 percent of income. (In addition, this group will benefit substantially from the scheduled repeal of the estate tax.)

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cuts that are highly skewed to households at the top of the income scale were not yet in effect in 2005, and since the CBO data do not take into account the reductions in the estate tax.

How a Regressive Tax Cut Can Increase High-Income Households' Share of Taxes Paid

To see how a regressive tax cut can increase the share of income taxes paid by high-income households, consider a hypothetical, very small country, one with just three taxpayers. The "high-income taxpayer" has an income of $1 million and pays $200,000 in income taxes. The "middle-income taxpayer" has an income of $40,000 and pays $1,600 in income taxes. And the "low-income taxpayer" has an income of $10,000 and pays $10 in income taxes. The country enacts a tax cut that reduces the high-income household's tax bill by $50,000, the middle-income household's tax bill by $800, and the low-income household's tax bill by $10. (Note: these tax-cut figures were chosen to resemble the actual figures for the 2001 and 2003 tax cuts. See the discussion on page 3.)

- The high-income household's tax cut equals 5 percent of its income; the middle-income household's tax cut equals 2 percent of its income; and the low-income household's tax cut equals 0.1 percent of its income. Because the tax cut is largest as a share of income for the high-income household, that household's share of the total after-tax income goes up, and the shares of income going to the other two households decline. Thus, the tax cut makes the country's tax system less progressive. (See the table below.)

- But, the high-income household in this example pays a larger share of total taxes as a result of the tax cut. This is because its $50,000 tax cut equals only 25 percent of its pre-tax-cut tax liability, while the middle-income household's $800 tax cut equals 50 percent of its tax liability, and the low-income household's $10 tax cut equals 100 percent of its tax liability. As a result, the low-income household's share of taxes paid falls to zero, and the middle-income household's share of taxes paid falls modestly — while the high-income household's share of taxes paid *increases* correspondingly. All this shows, however, is that the tax cut is larger *as a share of tax liability* for the middle- and low-income households than for the high-income household. It does *not* mean that after-tax inequality has narrowed or that the tax code is more progressive: as shown, the opposite is true.

Table 2: Hypothetical Tax Cut Example

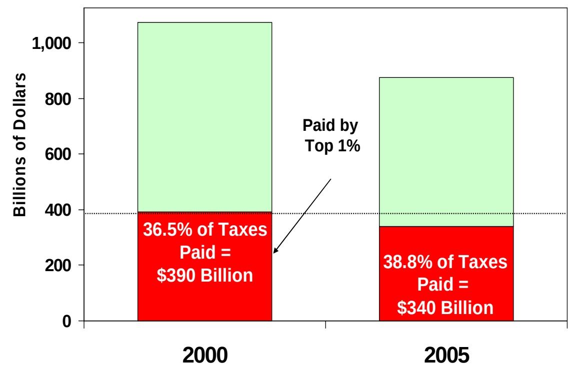
	Pre-Tax Income	Tax	After-Tax Income	Share of After-Tax Income	Share of Total Taxes Paid
Before the Tax Cut					
High-Income Household	$1,000,000	$200,000	$800,000	94%	99.2%
Middle-Income Household	$40,000	$1,600	$38,400	5%	0.8%
Low-Income Household	$10,000	$10	$9,990	1.2%	0.005%
Total	$1,050,000	$201,610	$848,390	100%	100.0%
After the Tax Cut					
High-Income Household	$1,000,000	$150,000	$850,000	95%	99.5%
Middle-Income Household	$40,000	$800	$39,200	4%	0.5%
Low-Income Household	$10,000	$0	$10,000	1.1%	0.0%
Total	$1,050,000	$150,800	$899,200	100%	100.0%
Note: Measuring the Tax Cut		***Dollars***	***Share of Income***	***Share of Pre-Tax-Cut Tax Liability***	
High-Income Household		*$50,000*	*5%*	*25%*	
Middle-Income Household		*$800*	*2%*	*50%*	
Low-Income Household		*$10*	*0.1%*	*100%*	
Total		*$50,810*	*NA*	*NA*	

Thus, the tax cuts for the top 1 percent were about twice as large as a percentage of income — and more than fifty-five times as large in dollar terms — as the tax cuts for households in the middle of the income scale. This made the distribution of income more unequal — the definition of a regressive tax cut. But since the tax cuts going to those at the top were smaller as a share of *income tax liability*, this group's share of income taxes paid increased somewhat. Put another way, these households now pay a modestly larger share of a considerably smaller revenue pie. (See Figure 2.)

FIGURE 2

Top 1 Percent is Paying a Slightly Larger Share of Total Income Taxes But Getting a Massive Tax Cut

Total Individual Income Tax Revenues, in 2005 Dollars, and Income Taxes Paid by Top 1 Percent of Households



Source: CBPP calculations based on CBO data

In short, changes in the percentage of taxes paid have no connection to tax progressivity, which relates to how taxes affect the distribution of income. Nor does an increase in the percentage of taxes that a group pays mean the group is shouldering a larger tax burden. The data are clear: the 2001 and 2003 tax cuts cut taxes much more as a percentage of income for those at the top than for anyone else and thereby made the distribution of after-tax income more unequal and the tax code less progressive.