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TAX FOUNDATION FIGURES DO NOT REPRESENT MIDDLE-INCOME TAX BURDENS

Figures May Mislead Policymakers, Journalists and the Public

by Joel Friedman, David Kamin, and Robert Greenstein

On April 6, the Tax Foundation released its report on "Tax Freedom Day," which it describes as the day when "Americans will finally have earned enough money to pay off their total tax bill for the year." Over the years, pundits and policymakers often have misinterpreted the Tax Foundation's reports as reflecting the level of the tax burdens that the broad swath of middle-income families must shoulder; the Tax Foundation's presentations invite this misinterpretation. In fact, however, *middle-income taxpayers pay significantly less in taxes as a share of their income than the Tax Foundation's report implies*.

Highlights

- The Tax Foundation's analysis employs averages in a misleading fashion that overstates the tax burdens of the vast majority of families. Analysis by authoritative institutions such as the Congressional Budget Office shows most Americans pay significantly less in taxes than the Tax Foundation reports.
- In figuring the percentage of income that families pay in taxes, the Tax Foundation counts taxes paid on capital gains but ignores the capital gains income on which these taxes are paid, an approach Alan Greenspan has said is invalid.
- The Tax Foundation analysis also counts as taxes certain *non-tax* items, like the premiums that older American can elect to pay for Medicare Part B, intra-governmental transfers, and rents that individuals or businesses pay to rent property that state or local governments own.

The Tax Foundation's annual Tax Freedom Day report consistently shows significantly higher tax burdens than those that authoritative, nonpartisan sources find middle-income taxpayers actually bear. This can be seen by comparing the Tax Foundation estimates of tax burdens to those that the Congressional Budget Office has just released for years through 2001, which the Center on Budget and Policy Priorities has updated through 2004. As the table below shows, CBO's estimates of the share of income that the middle fifth of American households pay in taxes have consistently been well below the levels of taxation that the Tax Foundation reports suggest average Americans pay.

- The report that the Tax Foundation has just released claims that the average American paid 22.2 percent of income in federal taxes in 2001. Yet the CBO analysis finds that the middle fifth of households paid 15.2 percent of their income in taxes that year.

- In 2004, the Tax Foundation estimates that federal taxes will consume 17.9 percent of the average American's income. Our update of the CBO estimate finds, however, that the middle fifth of households will pay an estimated 14.7 percent of their income in federal taxes this year.

Share of Income Going to Federal Taxes

	1999	2000	2001	2004*
CBO (middle fifth)	16.9%	16.7%	15.2%	14.7%
Tax Foundation (average)	22.5%	23.1%	22.2%	17.9%

**The "CBO figure" for 2004 reflects an estimate made by the Center on Budget and Policy Priorities, based on CBO, Tax Policy Center and other data.*

The Tax Foundation's conclusions conflict with CBO and Joint Tax Committee findings because the Tax Foundation uses a seriously flawed methodology that distorts — and inflates — tax burdens.

The Problems with the Methodology

In computing what it says is "the average American tax burden," the Tax Foundation divides what it says is total tax receipts by what it says is the total amount of income in the nation. The Tax Foundation method suffers from the following problems.

Average Tax Figure is Misleading

Under our progressive tax system, high-income taxpayers pay significantly greater percentages of income in federal income taxes than middle-income families do. Under the Tax Foundation methodology, the higher taxes that high-income taxpayers pay are used to make the taxes that average Americans pay look considerably larger than they actually are.

Suppose four families with incomes of $50,000 each pay $2,500 in income tax — five percent of their income — while one wealthy family with $400,000 in income pays $80,000 in

Greenspan Warns Against Seriously Flawed Approach Tax Foundation Uses

In a 2002 Congressional hearing, Federal Reserve Chairman Alan Greenspan warned that the type of approach the Tax Foundation uses — dividing total tax receipts by total income, as measured by the Gross Domestic Product or a similar measure, to determine an overall average tax rate — is not valid. Greenspan flatly stated: "you can't use tax receipts over nominal GDP as a tax rate." He explained one reason such an approach is improper: although capital gains taxes are counted as part of federal tax receipts, the capital gains *income* on which such taxes are paid is *not* counted in GDP. The Tax Foundation uses another, similar Commerce Department income measure (NNP, or Net National Product) that also omits capital gains. Counting capital gains taxes as part of tax receipts while failing to count as income the capital gains income on which these taxes are paid distorts — and inflates — average tax rates.

In this year's report, the Tax Foundation attempts to respond to such criticism. It asserts that the NNP measure "fully accounts for capital gains." But this claim is false. As the Bureau of Economic Analysis at the Commerce Department confirms, NNP does *not* include capital gains.

income tax, or 20 percent of its income. If one averages these figures, one finds that 15 percent of the total income of these five families goes to pay federal income taxes. (Dividing the families' total tax payments of $90,000 by their total income of $600,000 shows that 15 percent of their total income is paid in income taxes.)

Under the Tax Foundation methodology, this 15 percent figure would be used to say or imply that the average family in this group pays 15 percent of its income in income taxes and must work until 15 percent of the year has passed to pay its income tax bill. Yet the 15 percent figure is highly misleading as an indicator of the typical tax burden of families in this group. The four moderate-income families in the group pay five percent of their income in income tax, or one-third of the average 15 percent rate. Using averages in this fashion when talking about tax burdens, as the Tax Foundation does, produces skewed results; it essentially ascribes to average taxpayers the tax rates that only people at considerably higher income levels pay.

The Tax Foundation's State-by-State Data Also are Seriously Flawed

The Foundation's report also includes a list of the dates it says represent "Tax Freedom Day" for each states. The serious flaws that mar the Tax Foundation's estimates of tax burdens nationally plague its state-by-state estimates as well.

- About two-thirds of the tax burdens in the Tax Foundation calculations are federal tax burdens. The amount of federal taxes paid by the residents of a state thus has a large impact on that state's "Tax Freedom Day." Since, as this analysis explains, the Tax Foundation methodology substantially overstates the federal tax burden of middle-class families, the Tax-Freedom-Day figures for each state also substantially exaggerate the tax burdens of middle-class families.

- Because the federal income tax system is progressive, states with relatively wealthy residents — those with higher-than-average per capita personal income — end up under the Tax Foundation's methodology with a higher federal tax burden than other states. The fact that one state has higher-income residents than another state has nothing to do with the level of state and local taxes in a state. Yet by trumpeting state-level Tax Freedom Days that differ across the states, the Tax Foundation misleadingly implies that differences in burdens imposed by state and local taxes account for the differences across states in the Tax Foundation's "average tax burden."

- The Tax Foundation uses a procedure to allocate corporate and severance taxes based on the location of the consumers who purchase products that businesses sell (adjusted for taxes that tourists pay). This is likely to lead to further misimpressions about the role of a state's tax policies on the tax burdens its residents are said to face. For example, Maine residents consume a significant amount of fuel and thus pay energy taxes. Yet state legislators in Maine cannot have much impact on the level of taxes that Alaska or other oil-producing states levy on oil.

As a result, the Tax Foundation's proclamations of state Tax Freedom Days are misleading and do little to inform legitimate debates over levels of state and local taxes and the services those taxes support.

Taxes Counted, but Taxed Income *Not* Counted

Making the problem worse, the Tax Foundation methodology fails to provide an accurate representation of the average tax rate for the nation as a whole. In 2002, Alan Greenspan declared in a Congressional hearing in 2002 that the type of approach the Tax Foundation uses is not valid (see box on page 2). Despite Chairman Greenspan's warning that "you can't use" this measure, an admonition that other tax experts also have made in the past, the Tax Foundation repeats this error every year.[1]

Non-Tax Items Are Counted As Taxes

The Tax Foundation also counts as taxes certain items that are *not* taxes. These include Medicare premiums that older Americans elect to pay if they wish to receive coverage for physician's services under Medicare, intra-governmental transfers that are solely bookkeeping devices and not taxes, and rental payments that individuals or businesses pay to state or local governments to rent property those governments own.

Given these and other problems with the Tax Foundation measure, it is not surprising that the Tax Foundation's claims are inconsistent with the findings of the leading authoritative, institutions that study tax burdens, such as the Congressional Budget Office and the Urban Institute-Brookings Institution Tax Policy Center.

Tax Levels versus Expenditures on Food, Clothing and Medical Care

Finally, the Tax Foundation claims that families must pay more in taxes than they pay for food, clothing, and medical care combined. This Tax Foundation claim, which apparently compares total tax payments in the nation to total food, clothing, and medical care expenditures, may create further misimpressions.

If the statement that total tax payments exceed total expenditures for food, clothing and medical care is accurate (one cannot determine the accuracy of this assertion from the Tax Foundation report), this tells us little about the relationship between taxes and spending for families in the middle of the income scale. It is no doubt true that upper-income families pay more in taxes than they do for these items. It also is true that low- and moderate-income families pay significantly *less* in taxes than they spend for such items; necessities consume most of their income. The precise family income level at which taxes typically exceed expenditures for food, clothing and medical care is unclear. The Foundation’s report provides no information on that matter.

[1] One should note that taxes as a percent of GDP can offer some meaningful insights; for instance, it gives a sense of the share of the economy devoted to the public sector. But this calculation is inappropriate and misleading as a description of average households’ tax burdens.