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FEDERAL TAX BURDENS AT LOWEST LEVELS IN DECADES

By Joel Friedman and Isaac Shapiro

The percentage of income that most categories of taxpayers pay in federal taxes is at the lowest level in decades. Despite this fact — and despite the large current federal budget deficit and the even larger fiscal problems projected for coming decades — the Administration and Congress are pushing for additional tax cuts that would aggravate these problems.

Overall Federal Tax Burdens Are Low

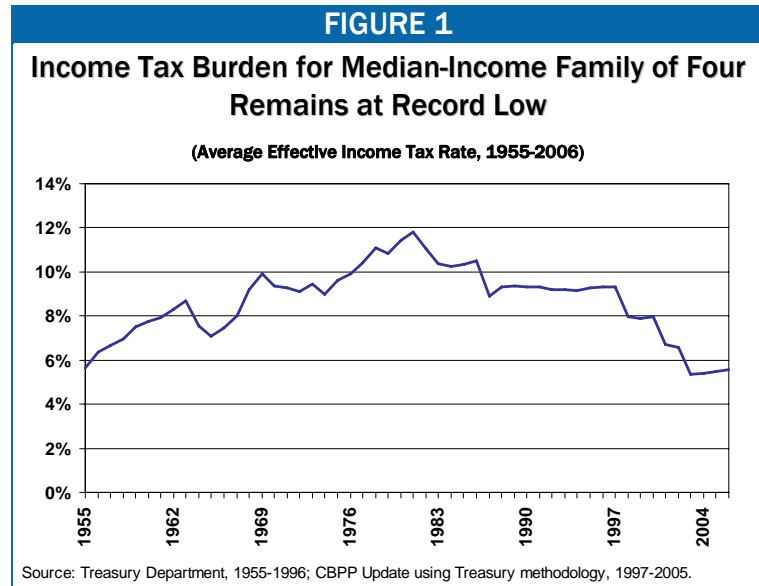
- Congressional Budget Office data show that most categories of households paid a smaller percentage of their income in federal taxes in 2003 than in any year on record, with data going back to 1979. These data, from a Congressional Budget Office study that covers the 1979-2003 period, include households' total federal tax burdens, including income, payroll, excise, and other taxes.¹
- For example, households in the middle fifth of the income spectrum paid an average of 13.6 percent of their income in federal taxes in 2003, the lowest level for any year between 1979 and 2003. Even in 2000, *before* the recent tax cuts, these households paid a smaller share of their income in federal taxes than in any year since 1979.
- The top one percent of households paid 31.4 percent of their income in federal taxes in 2003, the lowest level since 1992, and also lower than in 1979, 1980, and 1981, the first years covered in the CBO study. This percentage is higher than in the 1980s and the early 1990s, largely due to the effects of the very large tax cuts benefiting high-income households that were enacted in 1981.
- The tax burden fell significantly in 2003, with the phasing in of more of the tax cuts enacted in 2001 and the enactment of additional new tax cuts. In particular, high-income taxpayers benefited from the reduction of the top rate from 38.6 percent in 2002 to 35 percent and from the reductions in capital gains and dividend taxes that took effect in 2003.

¹ Congressional Budget Office, "Historical Effective Federal Tax Rates, 1979-2003," December 2005.

Federal Income-Tax Burdens Have Fallen Significantly

This drop in overall federal tax burdens has been driven by a pronounced decline in *income-tax* burdens.

- The Center estimates that the median-income family of four will pay only 5.6 percent of its income in federal income taxes in 2006, roughly the same as in 2003, 2004, and 2005. These “effective tax rates” represent the lowest levels on record, with data going back to 1955. (The Center’s estimates were derived by updating a 1998 Treasury Department analysis that examined changes since 1955 in the percentage of income that the median-income family of four pays in federal income taxes.³)



- Here, too, the downward trend began before the 2001 tax cut. In 2000, the median-income family of four paid a smaller percentage of its income in federal income taxes than in any year since 1966, except for 1998 and 1999.

Recent Tax Cuts Have Primarily Benefited High-Income Households

Although middle-income taxpayers, and particularly those with children, have benefited from the tax cuts enacted since 2001, the bulk of the benefits from those tax cuts have accrued not to middle-income families but to those with high incomes.

- Households that make more than \$1 million a year are receiving an average tax cut of about \$111,000 in 2006 from the 2001 and 2003 tax cuts, according to estimates by the Urban Institute-Brookings Institution Tax Policy Center. This is nearly 150 times the size of the average tax cut that families in the middle of the income scale are receiving (\$748).
- In 2006, the tax cuts will increase the after-tax incomes of this “millionaire” group by 5.7 percent, more than twice as much as the percentage gain for families in the middle of the income scale (2.5 percent).

² Office of Tax Analysis, Department of the Treasury, “Average and Marginal Federal Income, Social Security and Medicare, and Combined Tax Rates for Four-Person Families at the Same Relative Positions in the Income Distribution, 1955-1999,” January 15, 1998. The median-income family of four is in the exact middle of the income spectrum: half of all families of four have higher incomes, while the other half have lower incomes.

- This increase in after-tax income for those at the top of the income spectrum will exacerbate underlying trends that have led to an increasing concentration of income at the pinnacle of the income scale. CBO data show, for instance, that the average after-tax income for the top one percent of households grew 129 percent between 1979 and 2003, after adjusting for inflation, while households in the middle of the income spectrum experienced an average increase of only 15 percent over this period.³

Large Tax Cuts, Large Deficits

In 2005, federal revenues were well below their historical average as a share of the economy. Projections by the Congressional Budget Office show that, if the 2001 and 2003 tax cuts and accompanying Alternative Minimum Tax relief are extended, revenues as a share of the economy over the next decade will be below the average levels of the 1960s, 1970s, 1980s, or 1990s. This weakening of the federal revenue base has been a major cause of the stunning fiscal deterioration of the past few years.

In contrast, federal *spending* is not at particularly high levels as a share of the economy, even with the increases in spending for Iraq, hurricane relief, and anti-terrorism efforts. CBO projects that total federal spending in 2006 will be lower as a share of the economy than in any year from 1980 through 1995 and lower than the average for the period 1975-2005.

Over the next decades, as the baby-boomers retire in large numbers, the nation is projected to face persistently large deficits that ultimately may do significant damage to the economy. The data presented here thus suggest that policymakers should be considering how to shore up the revenue base and whether the tax cuts adopted in recent years remain affordable. Instead, the budget put forward by the President, as well as the budgets that have been adopted by the House Budget Committee and the Senate, all include further tax cuts. Partly as a result, all three budgets would cause the deficit to be *larger* than if we simply maintained current policies.

Most immediately, Congress is considering tax reconciliation legislation that would extend the capital gains and dividend tax cuts beyond their currently scheduled expiration, as well as pension legislation that would, for the first time, make permanent certain of the 2001 tax cuts, without paying for them. These actions could set a dangerous precedent for extending other tax cuts enacted since 2001 without offsetting their costs. Doing so would be especially ill-advised in light of looming large deficits and historically low tax burdens.

³ Isaac Shapiro and Joel Friedman, "New CBO Data Indicate Growth in Long-Term Income Inequality Continues," Center on Budget and Policy Priorities, January 30, 2006.