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## ARE TAXES EXCEPTIONALLY CONCENTRATED AT THE TOP?

### Treasury Department Release Creates Misleading Impression About Taxes That High-Income Taxpayers Pay

By Joel Friedman, Robert Greenstein, and Isaac Shapiro

The Treasury Department recently released a fact sheet on who pays the federal income tax. The fact sheet makes two main points: that “the individual income tax is highly progressive — a small group of higher income taxpayers pay most of the individual income tax each year,” and that this burden has *increased* as a result of the tax cuts enacted under the Bush Administration.<sup>1</sup>

The Treasury release is designed to counter arguments that the recent tax cuts are tilted to those at the top of the income scale and to portray the tax cuts enacted since 2001 in a positive light. The fact sheet, however, is misleading. By focusing only on the federal income tax and leaving out all other federal taxes, it creates misimpressions both about the degree to which the tax code is progressive and about who benefited the most from the recent tax cuts. The fact sheet also ignores the degree to which income has become more concentrated at the top of the income scale.

- **While the nation’s tax code is progressive, it is not nearly as progressive as the Treasury fact sheet would lead one to believe.** The Treasury analysis shows that the one percent of taxpayers with the highest incomes paid 33.9 percent of federal individual income taxes in 2001. However, a new analysis by the Congressional Budget Office shows that this group pays a substantially smaller proportion — 22.7 percent — of federal taxes overall, including payroll, excise, and other taxes.<sup>2</sup> The progressivity of the tax system is further muted if state and local taxes are taken into account; most state and local tax systems are regressive.
- **High-income households have clearly gained the most from recent tax cuts.** As a result of the three major tax cut bills enacted since 2001, the top one percent of taxpayers will receive average tax cuts of nearly \$35,000 in 2004, according to new data from the Urban Institute-Brookings Institution Tax Policy Center, or 54 times the average tax cut that the middle fifth of taxpayers will receive. The highest-income taxpayers also will experience a much greater percentage increase in after-tax income as a result of the tax cuts than other taxpayers will. Finally,

<sup>1</sup> Treasury Department, “Fact Sheet: Who Pays The Most Individual Income Taxes?” April 1, 2004.

<sup>2</sup> Congressional Budget Office, “Effective Federal Tax Rates, 1979-2001,” April 2004.

the Tax Policy Center data show that those at the top of the income scale will be paying a smaller share of all federal taxes when the tax cuts are fully in effect.

- **High-income households paid a larger share of federal taxes in 2001 than in the first half of the 1990s — the years that the Treasury fact sheet covers — but this is due in significant part to high-income households receiving a larger share of before-tax income in the nation in 2001 than in the early 1990s.** In addition, even after taxes are taken into account, *after-tax* income increased much faster for high-income households over the 1990-2001 period than for any other income group. The CBO data show that from 1990 to 2001, the average after-tax income of the top one percent of the population jumped 41 percent, while the average after-tax income of the middle fifth of the population rose 14 percent. When the 1980s are included, this differential is even larger (see box on page 6).
- **The tax burden on high-income households is not high in historical terms.** As just noted, high-income taxpayers are paying a larger share of federal taxes in significant part because they are receiving a larger share of the national income. But their actual tax burdens — the percentage of income they pay in federal taxes — have *declined*. According to the CBO data, the top one percent of households paid a slightly smaller share of their income in federal taxes in 2001 than they paid in any year since 1992. Further, since 2001, the percentage of income they pay in federal taxes has dropped significantly as tax cuts targeted on them — such as the reduction in the top income tax rates — have taken fuller effect.

## How Progressive Is The Nation's Tax Code?

The Treasury fact sheet focuses only on the individual income tax, one of the most progressive taxes. Not surprisingly, it shows that high-income households pay a large share of this tax. But the degree to which high-income households shoulder the tax burden is lessened once payroll taxes are taken into account. Although the progressive individual income tax is the single largest source of federal revenue, the payroll tax — which is regressive — is a very close second, accounting for between 35 percent and 40 percent of all federal taxes in recent years.<sup>3</sup> The payroll tax places a larger burden on low- and moderate-income families than the income tax because it is levied on the first dollar of wages. According to CBO, more than three-quarters of workers paid more in payroll than in income taxes in 2000, the latest year for which these data are available.<sup>4</sup>

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<sup>3</sup> CBO estimates that in 2004, individual income taxes and payroll taxes will represent nearly equal shares of total federal taxes, with individual income taxes representing 42 percent of the total and payroll taxes representing 41 percent. After 2004, assuming extension of the tax cuts, the share attributable to individual income taxes is projected to rise somewhat and the share attributable to payroll taxes to fall modestly.

<sup>4</sup> Congressional Budget Office, "Effective Federal Tax Rates, 1979-2000," August 2003. This calculation follows the standard practice of attributing to workers the burden of both the employee and employer payroll taxes, with the employer portion being passed on to workers in the form of lower wages.

As a result, the CBO data show that the top one percent of households paid 22.7 percent of all federal taxes in 2001, significantly below the 34.4 percent of individual income taxes that CBO estimates this group paid.<sup>5</sup>

The CBO data also indicate that in 2001, the top one percent of households received 14.8 percent of the before-tax income in the nation, eight percentage points less than the share of total federal taxes they paid. This indicates that the federal tax system overall is progressive, but not to the steep degree the Treasury fact sheet implies.

Furthermore, taxes also are paid to state and local governments, which tend to rely more heavily on regressive sales taxes and excise taxes. When state and local taxes are included, the gap between the percentage of the national income that high-income individuals receive and the percentage of the taxes they pay narrows further, a point the noted tax expert Joseph Pechman demonstrated nearly two decades ago.

New estimates by the Citizens for Tax Justice confirm this conclusion. They show that in 2004, when more of the recently enacted tax cuts are in effect, the overall share of federal, state, and local taxes that high-income households will pay will be only a little bit larger — less than two percentage points larger — than their share of the national income. Similarly, the share of taxes that middle- and lower-income households pay will be just a little more than one percentage point lower than their share of the national income, according to these CTJ estimates.<sup>6</sup> It is only because the progressive federal tax system offsets the regressive effects of state and local taxes that the U.S. tax system as a whole is even mildly progressive.

## Who Gains The Most From The Tax Cuts?

According to the Treasury Department fact sheet, “The President’s tax cuts have shifted a larger share of the individual income taxes paid to higher income taxpayers. In 2004, when most of the tax cut provisions are fully in effect (e.g., lower tax rates, the \$1,000 child credit, marriage penalty relief), the projected tax share for lower-income taxpayers will *fall*, while the tax share for higher-income taxpayers will *rise*.” These statements appear intended to create the impression that the tax cuts were distributed in a highly equitable manner, giving households that do *not* have high incomes more than their fair share. This is not the case.

The tax cuts enacted since 2001 benefit high-income households the most, by far, and are exacerbating the concentration of after-tax income at the top of the income scale, according to estimates prepared by the Urban Institute-Brookings Institution Tax Policy Center. Economists generally believe changes in after-tax income constitute the most appropriate measure of the

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<sup>5</sup> The CBO estimate (34.4 percent) is slightly higher than the Treasury estimate (33.9 percent). This small discrepancy exists largely because the two institutions employ somewhat different concepts of income and of the populations their analyses cover.

<sup>6</sup> Citizens for Tax Justice, “Overall Tax Rates Have Flattened Sharply Under Bush,” April 13, 2004. CTJ estimates that in 2004, the top one percent of households will receive 19.1 percent of the nation’s income and pay 20.8 percent of federal, state, and local taxes. The CTJ figures reflect concepts of income and of the population covered in its analysis that are slightly different than those used by CBO and Treasury.

distributional impact of tax cuts, since after-tax income represents the best measure of the income that a household has available to spend or save. The Tax Policy Center analysis shows that the tax cuts enacted since 2001 will increase after-tax income in 2004 for households in the middle of the income spectrum by an average of 2.3 percent, while increasing after-tax income for those in the top one percent of the income scale by 5.3 percent — or twice as large as a percentage. For those with incomes over \$1 million, the tax cuts will increase after-tax income by 6.4 percent in 2004.

**Table 1: Impact of Enacted Tax Cuts, 2004**

Income Class	Average tax cut	Percentage growth in after-tax income
Middle 20 percent	\$647	2.3%
Top one percent	\$34,992	5.3%
Over \$1 million	\$123,592	6.4%

*Source: Urban-Brookings Tax Policy Center*

The Treasury fact sheet tries to create the illusion that the tax cuts are progressive by stating that the top one percent will pay a larger share of the individual income taxes after the tax cuts than before the tax cuts. By itself, this type of comparison is not especially meaningful for assessing the progressivity of the tax cuts. Essentially, this statistic tells us that the upper-income group will be paying a slightly larger share of the *much smaller amount* of federal income taxes that will be collected after the tax cuts. Taken to its logical extreme, if all income taxes were eliminated except for a tax of \$1 a year on the top one percent of households, these high-income households would be paying 100 percent of all income taxes. Yet such an outcome would represent a regressive change, because the progressive income tax code would have essentially been eliminated, which would presumably lead to increases in other, less progressive taxes or to reductions in programs that primarily benefit middle- and low-income households, as most major federal programs do.<sup>7</sup>

In addition, the Treasury produces its “finding” that high-income households are paying a modestly larger share of federal income taxes by ignoring all taxes other than the income tax and also ignoring years after 2004. The fact sheet leaves out tax cuts enacted in 2001 that are scheduled to be phased in *after* 2004, including income-tax cuts benefiting only higher-income households that have not yet taken effect as well as the repeal of the estate tax. A more complete analysis by the Tax Policy Center shows that when all of the tax cuts are fully in effect, the top one percent will pay a slightly smaller share of federal taxes as a result of the tax cuts, not a larger share.<sup>8</sup>

<sup>7</sup> How tax cuts are paid for is particularly relevant in the current context, where deficits that have been generated in significant part by the tax cuts are spurring calls for deficit reduction. Because the tax cuts are tilted toward the highest-income households, the burden of financing these tax cuts ultimately is likely to be borne primarily by households that gain much more modestly from the tax cuts. This will be the case unless the spending cuts or tax increases used to shrink the deficit reduce benefits or raise taxes primarily on high-income households. Over the long term, most Americans thus may end up as net losers from the tax cuts.

<sup>8</sup> Other Tax Policy Center data also show that households with very high incomes will receive outsized benefits from the tax cuts. For instance, TPC data indicate that in 2004, households with incomes of more than \$1 million will receive 9.1 percent of the before-tax income in the nation and would pay 13.6 percent of all federal taxes in the

## Large Share Of Taxes Paid By Top One Percent Reflects The Increased Concentration Of Income

New CBO data show that the before-tax income of the top one percent of the population grew by 125 percent between 1979 and 2001, the years the CBO analysis covers. (All of these figures are adjusted to remove the effects of inflation.) In contrast, the incomes of those in the middle of the income scale grew by 12 percent over this period, or at one-tenth the pace of the top one percent. In dollar terms, the top one percent experienced a \$583,300 average increase in income over this period, while those in the middle saw their incomes grow by an average of \$5,500.

**Table 2: Growth in Before-Tax Income\*  
1979-2001**

Income Class	Percentage Increase	Increase in Dollars
Middle 20 percent	12.0%	\$5,500
Top one percent	125.0%	\$583,300

*\*Adjusted for inflation  
Source: CBO*

As a result of the rapid income growth at the top of the income scale, the share of the nation's income that flows to those with high incomes grew substantially over this period. According to CBO, the top one percent received 14.8 percent of the nation's before-tax income in 2001, up sharply from this group's 9.3 percent share in 1979.<sup>9</sup> Since 1996, the households that make up the top one percent of the population have received a larger share of the national income than the entire 20 percent of the population in the middle of the income spectrum.

Similarly, the top five percent received about as much income in 2001 as the bottom 60 percent of the population. That is, the 5.7 million households with the highest incomes (the top five percent) received as much income as the bottom 64.9 million households combined.

**Table 3: Shares of Before-Tax Income**

Income Class	1979	2001
Middle 20 percent	15.8%	14.2%
Top one percent	9.3%	14.8%

*Source: CBO*

Given that those at the top of the income spectrum are receiving a larger share of the national income than in the past, it is not surprising that they are paying a larger share of federal taxes.

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absence of the tax cuts. But they will receive 15.3 percent of the tax-cut benefits in 2004, which is larger than both the share of federal taxes they pay and the share of the national income they receive.

<sup>9</sup> The share of income going to the top one percent was lower in 2001 than in 1998 through 2000, reflecting in large part the drop in the stock market. There are no official data available on income shares after 2001.

## **After-Tax Income Gains Also Have Been Concentrated at the Top**

Although households with high incomes pay a larger share of their income in federal taxes than other income groups do, their income *after-taxes* has grown much more rapidly over the past two decades than the after-tax income of other households. After-tax income is the best indicator of a household's well-being, because it shows the level of income that a household has to spend, save, or invest.

CBO estimates that the average after-tax income of the top one percent of households grew by a stunning 139 percent between 1979 and 2001. In contrast, the incomes of those in the middle of the income spectrum grew by an average of 17 percent over this period. In dollar terms, the top one percent experienced a \$408,800 average increase in after-tax income over this period, while those in the middle saw their incomes grow by an average of \$6,300. (These figures are adjusted to remove the effects of inflation.)

The CBO data also show marked disparities in after-tax income growth since 1990, the first year the Treasury fact sheet covers. After-tax income grew much faster among high-income households between 1990 and 2001 than among ordinary households, despite the fact that the overall tax rates that the top one percent of households faced were higher in 2001 than in 1990, as a result of deficit-reduction measures enacted in 1990 and 1993. According to the CBO data:

- Between 1990 and 2001, the average after-tax income of the top one percent of households rose from \$500,400 to \$703,100. This represents a robust average gain of more than \$200,000 per household, or 41 percent.
- Middle-income households gained much more modestly over this period. The average after-tax income of the middle fifth of households rose by \$5,300, or 14 percent.

### **Growth in After-Tax Income \***

Income Class	1990-2001		1979-2001	
	Percentage Increase	Increase in Dollars	Percentage Increase	Increase in Dollars
Middle 20 percent	13.8%	\$5,300	16.8%	\$6,300
Top one percent	40.5%	\$202,700	138.9%	\$404,800

*\* Adjusted for inflation*

*Source: CBO*

## **Tax Burden For Upper-Income Households Has Declined**

Finally, the CBO data show that the percentage of income that higher-income households pay in federal taxes was *lower* in 2001 than in a number of the previous years covered by the CBO study.

- CBO estimates that in 2001, the top one percent of households paid an average of 33 percent of their income in federal taxes, including income, payroll, and other taxes.

- This percentage is lower than in any year since 1992. It also is lower than the average for the 1990s.
- The percentage is lower than in 1979 and 1980 as well, the first years that the CBO study covers. The percentage is higher than in most years of the 1980s and early 1990s, which should not be surprising given the very large tax cuts for high-income households that were enacted in 1981. It also should be noted that the 1980s and early 1990s were marked by large federal deficits and substantial increases in the national debt.

One key point is that these CBO estimates for 2001 reflect the effects of only a small fraction of the recent tax cuts that have benefited high-income households handsomely. The top income tax rate stood at 39.1 percent in 2001, down only slightly from the 39.6 percent rate before the tax cuts. Today, the top tax rate is significantly lower at 35 percent. In addition, the recent tax cuts on dividend and capital gains income were not enacted until 2003. When all of the recent tax cuts are in full effect, the share of income that high-income households pay in federal taxes will be significantly lower than it was in 2001. As just noted, the 2001 level itself was below the level for all years since 1992, as well as for 1979 and 1980.

## **Conclusion**

The Treasury Department fact sheet continues a trend by the Administration and the Treasury Department's public affairs office of using statistics selectively to create questionable impressions about the nature of the nation's tax burden and the impact of the tax cuts enacted since 2001. In general, the overall tax system is only modestly progressive. The share of federal taxes that high-income households pay has risen in recent decades, but this is in significant part because these households' incomes have risen more rapidly than everyone else's and they now receive a substantially larger share of the national income.

Moreover, the percentage of income that high-income households pay in federal taxes has been declining since 1996, was already lower in 2001 than in any year since 1992, and has fallen significantly further since 2001 as more tax cuts have taken effect.