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TAXES ON MIDDLE-INCOME FAMILIES ARE DECLINING

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Taxes on middle-income families have fallen over the past few years. The percentage of income that these families pay in taxes is now at the average level of the past two decades.

- Data on federal taxes from the two leading sources of tax information for Congress — the Congressional Budget Office and the Joint Committee on Taxation — indicate that the federal tax bite on families in the middle of the income distribution is smaller than it was four years ago. Families with incomes of approximately $40,000, for example, would be paying about $580 less in 2001 than they would have paid if they still were paying the same percentage of income in federal taxes as in 1995. Tax burdens on these families have declined by an amount that equals about one percent of their income.

- Data from the Congressional Budget Office, which go back to 1977, show that the percentage of income paid in federal taxes in 1999 by the fifth (or 20 percent) of families squarely in the middle of the income spectrum was at the average level that such families have paid over the 1977-1999 period.

Table 1
Percent of Income Middle Income Families Pay in Taxes

Federal	1995	1999	2001
CBO	19.7%	18.9%	—
JCT			
$30-40,000	17.3%	—	16.2%
$40-50,000	19.3%	—	17.5%
State and Local			
Average Taxes	10.3%	10.3%	10.3%
TOTAL			
CBO for federal tax	**30.0%**	**29.2%**	**—**
JCT for federal tax	**27.6% to 29.6%**	—	**26.5% to 27.8%**

Source: Congressional Budget Office, May 1998; Joint Committee on Taxation, November 14, 1995 and July 20, 2000; U.S. Department of Commerce, Bureau of Economic Analysis, March 2000.[1]

- If just federal *income* taxes are examined, Treasury Department data show that a median-income family of four with two children is paying a *smaller* percentage of income in federal individual income taxes than at any time *in more than three decades*.

- Nor does the inclusion of state and local taxes alter this picture. Data from the Commerce Department show that the overall burden imposed by these taxes has been relatively stable in recent years, as well as over the past few decades.

To be sure, the total amount of taxes collected by the federal government, measured as a percentage of the Gross Domestic Product, has risen in recent years. This increase has been driven by increased collections from high-income taxpayers, *not* by increased taxes on middle-income taxpayers. CBO, conservative economist Lawrence Lindsey, and Federal Reserve Board chair Alan Greenspan, among others, all have found that the increased collections are due largely to a large jump in capital gains income and to bonuses paid to highly-compensated executives.

Middle-Income Tax Burdens are Declining

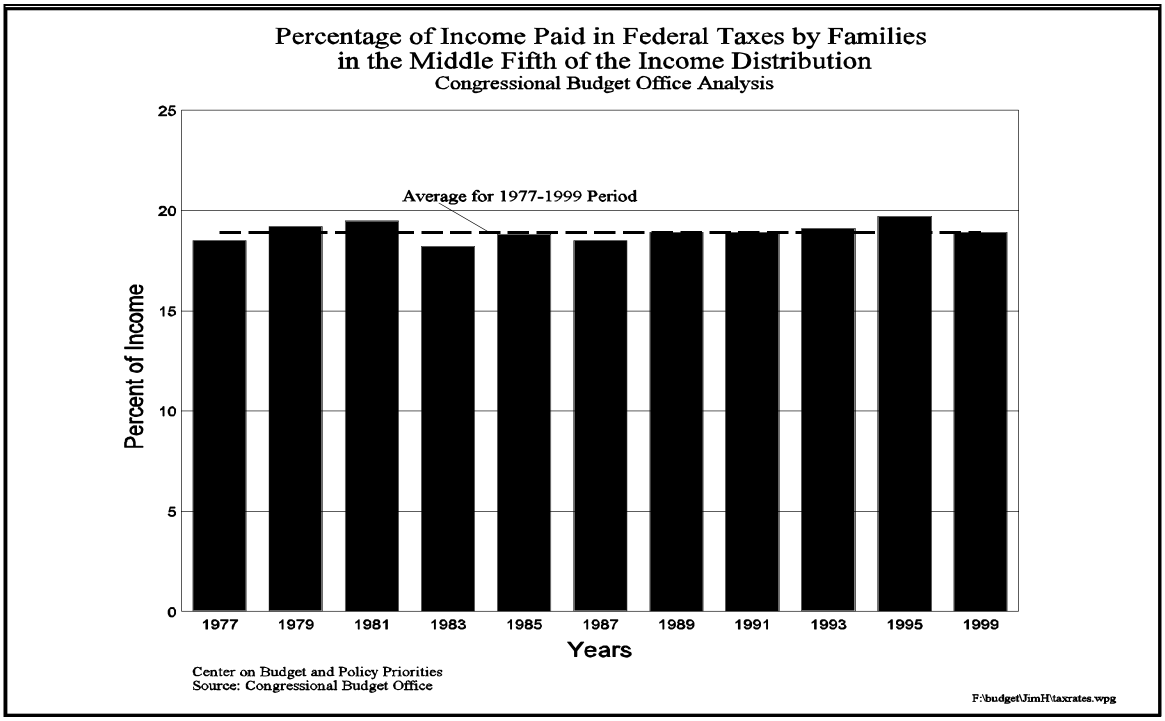
Analyses by both the Congressional Budget Office and the Joint Committee on Taxation show the combined federal tax burden of middle-income families has declined.

- A ***Congressional Budget Office*** analysis shows that families in the middle of the income distribution paid an average of 18.9 percent of their income in federal taxes in 1999. This is down from 19.7 percent of income in 1995. The CBO analysis includes the effect of income taxes, Social Security and other social insurance taxes, excise taxes, and corporate income taxes. (The average family in the middle of the income distribution had income of approximately $39,000 in 1999.)[2]

- The average federal tax burden imposed on these families in 1999 is about the same as the average burden they faced over the 1977-1999 period. (See Chart 1. This CBO data series begins in 1977.)

- According to the ***Joint Committee on Taxation***, families with income between $30,000 and $40,000 will pay an average of 16.2 percent of their income in federal taxes in 2001, while families with income between $40,000 and $50,000 will pay 17.5 percent of income in taxes. The Joint Committee analysis includes the effect of income taxes, Social Security and other payroll taxes, and excise taxes, but not corporate income taxes.

  Federal tax burdens have declined in recent years for families in both income categories. The Joint Committee data show that federal taxes on families with income between $30,000 and $40,000 have declined from an average of 17.3 percent of income in 1995 to 16.2 percent of income in 2001. Federal taxes on families with income between $40,000 and $50,000 have declined from 19.3 percent of income to 17.5 percent of income over this period.[3] (Changes in the Committee's methodology preclude consideration of a longer historical time period.)



- Families in the middle of the income spectrum paid approximately $300 less in taxes in 1999 than they would have paid if tax burdens had remained constant between 1995 and 1999. (Using the CBO figures, the 0.8 percentage point drop in taxes from 19.7 percent of income in 1995 to 18.9 percent of income in 1999 multiplied by the $39,000 average income is $312.)

- Using the JCT figures, a family with income of approximately $40,000 will pay about $580 less in taxes in 2001 than it would have paid if tax burdens had remained constant between 1995 and 2001. (The 1.1 percent drop in tax burden for families with incomes between $30,000 and $40,000 averaged with the 1.8 percent drop for families with incomes between $40,000 and $50,000 yields a 1.45 percent drop in tax burden for families at approximately $40,000 for a reduction in taxes of $580.)

Families pay state and local taxes as well. Unfortunately, there are no data that would allow determination of the level or trend in total state and local taxes borne by middle-income families. But data on total state and local taxes as a percentage of the economy suggest these taxes have been stable in recent years.

- Commerce Department data show that state and local taxes amounted to 10.3 percent of Net National Product in both 1995 and 1999. This Commerce Department measure of state and local taxes has been remarkably stable over time; it was at almost the same level in 1999 and throughout the 1990s as in 1977.[4]

The Declining Tax Burden on American Families

The following is an excerpt from remarks by Lawrence H. Summers at the Brookings Institution, April 18, 2000 that includes findings similar to those in this report:

"...the tax burden for most American families is at its lowest in a generation. Consider:

For a family of four with half of median income — about $29,000 — Federal income and payroll taxes are a smaller share [of income] than at any time since 1977.

For a family with median income — about $59,000 — Federal income plus payroll taxes are now a smaller share of income than at any time since 1978, and Federal income taxes alone are the smallest share since 1966.

Even a family with double the median income — about $117,000 — pays less in Federal income taxes as a share of their income than at any time since 1974. I note that 90 percent of American families have incomes below $117,000.

It is true, as some have noted, that tax collections are rising as a share of GDP. But this does not reflect increases in tax burdens on particular categories of taxpayers. Taxable incomes have risen as a share of GDP because of the effects of a rising stock market. Capital gains are not a part of GDP. Therefore, any increase in capital gains drives the ratio of taxes to GDP higher without raising the share of income paid as taxes by families. In addition, higher-income families and corporations have been earning an increasing share of GNP, and they are taxed at a higher rate. All these factors have boosted revenues without raising the tax bills of the vast majority of American families."

Note: The full speech is available at http://www.ustreas.gov/press/releases/ps561.htm

- This indicates that *average* state and local tax burdens — as distinguished from the tax burdens of typical middle-income families — have been relatively constant in recent years.

As described below, the overall *average* federal tax rate has been rising, largely as a result of tax collections attributable to booming stock-market profits. This phenomenon has little effect on middle-income taxpayers, however, because income on these profits is concentrated among people at higher income levels. In addition, the large number of state tax cuts enacted in recent years suggests that state and local taxes on middle-income families may be declining, even though average state and local tax rates are stable. Nearly two-thirds of the states have enacted significant tax cuts in recent years.

Are Tax Burdens Rising Overall?

Total federal tax collections measured as a percentage of the economy — taxes as a percentage of GDP — have risen in recent years. So have overall average tax burdens as shown in Census data. These increases are due in large part to the extraordinary increase in capital gains income and other income that high-income taxpayers have received over the past few years as the stock market has soared. But the increases in capital gains tax collections and taxes on bonuses and other income that highly-compensated executives receive have little effect on the tax burdens of most Americans.

- According to tax statistics reported by the Internal Revenue Service, the amount of net capital gains reported on tax returns jumped nearly 23 percent from 1996 to 1997, while wage and salary income rose 6.6 percent. The IRS reports that more than 92 percent of the net capital gains in 1997 were on tax returns of taxpayers with income exceeding $40,000 — that is, taxpayers with income above the median.

- A Congressional Research Service study, based on Joint Committee on Taxation data for 1999, finds that *three-quarters* of all capital gains taxes are paid by the 1.8 percent taxpayers with incomes *exceeding $200,000*. The bottom third of taxpayers pay almost no capital gains taxes. The middle third of taxpayers pay about one percent of these taxes.[5]

- Former CBO director June O'Neill testified in 1998, in her capacity as CBO director, that tax receipts have risen in recent years as a share of the Gross Domestic Product in 1998, "mainly because realizations of capital gains were unusually high and because a larger share of income was earned by people at the top of the income ladder, who are taxed at higher rates."[6]

- Sounding a similar note in testimony before Congress in January 1999, Lawrence Lindsey, an economist who served in the Reagan and Bush administrations and on the Board of Governors of the Federal Reserve System, said, "A disproportionate share of this extra revenue is coming from upper income taxpayers through higher income tax payments. The likely reason for these payments is the booming stock market. The extra revenue is in part due to higher capital gains realizations due to higher stock prices, but is probably even more dependent upon higher bonuses being paid to upper bracket individuals."[7] Neither of these developments has much or any effect on families in the middle of the income scale.

- Federal Reserve Board Chair Alan Greenspan also has made this same point. He testified in January 1999 that "...we have had a very significant rise in individual tax receipts which unquestionably are reflective of the very large capital gains; and, secondarily, the impact of rising stock prices on other types of income."[8]

- A more formal analysis of the increase in taxes as a percentage of GDP was published by the Congressional Budget Office in January 2000. It found that between 1994 and 1998, capital gains realizations nearly tripled. The increase in capital gains taxes alone accounted for nearly one-third of the increase in tax collections relative to GDP.

  The CBO analysis also found that a large share of the increase in taxes relative to GDP could be attributed to growth of other types of income that are concentrated at the top of the income distribution. The share of income (other than capital gains) going to taxpayers with adjusted gross income above $200,000 rose from 14.5 percent in tax year 1993 to 21.6 percent in tax year 1998, after adjustment for inflation. This income growth increased the percentage of income paid in taxes for taxpayers as a whole because the proportion of income that is taxed at the highest tax rates rose.[9] In other words, most of the factors driving the increase in taxes as a percentage of GDP have little, if any, effect on median-income families.

Moreover, measuring tax burdens as a percentage of GDP can be misleading. Taxes paid on capital gains income *are counted* as part of total tax collections, but capital gains income itself *is not counted* as part of GDP. This means that when measuring taxes as a percentage of GDP, capital gains taxes are counted but the income on which these taxes are paid is not.

As a result, when capital gains income and capital gains tax collections both rise sharply, as has occurred in recent years, tax burdens measured as a percentage of GDP rise *more rapidly than tax burdens are actually increasing*. With capital gains income now playing a major role in the increase of federal revenues, this distortion has taken on added importance.

Increases in taxes as a percentage of GDP have little bearing on whether taxes on median-income families are rising. The recent evidence shows that increases in taxes on high-income taxpayers are pulling up average taxes at the same time that taxes on typical middle-income families are declining. Indeed, measures such as taxes as a percentage of GDP no longer even accurately portray changes in *average* taxes because of the distortion that results from failing to count capital gains income. As a result of these two problems, those who cite increases in taxes as a percentage of GDP — or increases in average tax burdens — as evidence that tax burdens on typical middle-class families are rising commit a double error and disseminate misleading information as a consequence.

Recent Tax Cuts Have Driven Down Tax Burden

The percentage of taxes that typical middle-class families pay in total taxes has been declining in large part because federal income tax burdens on families — and particularly on families with children — are sharply lower than they were 10 or 20 years ago. The federal $500 per child credit and education credits and deductions have lowered taxes on middle-income families with children.

The Tax Foundation's Average Tax Measure
Does Not Reflect What Typical Middle-Class Families Pay in Taxes

Each year around April 15, the Tax Foundation issues a report about what it calls "Tax Freedom Day." This year, the Tax Foundation claims that "the nation's taxpayers" must work until May 3, 2000 to pay their taxes for 2000. In making this claim, the Tax Foundation relies on a measure of average taxes; the Foundation takes what it says is the total amount paid in federal, state, and local taxes and simply divides this amount by its estimate of the total amount of income in the nation. It calls this figure the taxes that Americans pay on average. For a number of reasons, the Tax Foundation calculation is a deeply flawed measure of the percentage of income that most Americans pay in taxes. Moreover, the Tax Foundation's presentation of these figures invites middle-income taxpayers to believe that they pay considerably more of their income in taxes than the data show to be the case.

Average tax figure misleading. The average tax burden for the population as a whole is a figure that misleads many people and is frequently misused. This figure often is cited by policymakers and pundits as reflecting what the average or typical middle-class family pays in taxes. But middle-class families do *not* pay the average tax burden; they pay substantially less than that. This is a result of the progressive structure of the federal income tax, under which the wealthy pay a substantially higher percentage of income in federal taxes than the middle class or the poor do. While the typical middle-income family is in the 15 percent federal income tax bracket, high-income families are in brackets with marginal rates more than twice that high and pay much higher percentages of income in federal income tax than middle-class families do.

The problem of using averages is easily seen. Suppose four families with $25,000 incomes each pay $1,250 in income tax — or five percent of their income — while one wealthy family with $500,000 in income pays $125,000 in income tax, or 25 percent of its income. On average, these five families pay 22 percent of income in federal income taxes (total tax payments of $130,000 divided by total income of $600,000 equals 22 percent). But the 22 percent figure is misleading if used to portray middle-class tax burdens. The four moderate-income families pay five percent of income in income tax, not 22 percent.

Using averages for the whole population when talking about tax burdens for the average middle-class family produces skewed results. It ascribes to middle-class families average amounts of such taxes as the estate tax and the corporate income tax. These taxes, however, are paid solely or primarily by taxpayers at considerably higher income levels than the average middle-class taxpayer. The CBO and Joint Tax Committee data find that average federal tax burdens for the middle fifth of the population are substantially lower than the federal tax burdens in the Tax Foundation report. The Tax Foundation estimates for 1999 were between one-fourth to one-half higher than the estimates of average tax burdens for families in the middle of the income spectrum made by these respected sources of analysis for Congress. That is because the CBO and JCT figures are not distorted by the taxes that high-income families pay.

Non-tax items counted. In making its calculation, the Tax Foundation counts as taxes items that are *not* taxes. These include: optional Medicare premiums that older Americans pay if they wish to receive coverage for physicians' 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.

Taxes counted, but taxed income *not* counted. The tax measure the Tax Foundation uses in its "Tax Freedom Day" report counts capital gains taxes as part of the taxes people pay, but fails to count as part of people's income the capital gains income on which these taxes are levied. Counting taxes while failing to count the income on which the taxes are paid makes taxes appear larger as a percentage of income than they truly are. In addition, in a period such as the present when capital gains income and hence taxes on such income are rising rapidly, the Tax Foundation procedure makes even average tax burdens appear to be growing faster than they actually are growing.

These flaws in measurement of taxes and income have led the Tax Foundation to show that taxes are rising, when data from authoritative sources show tax burdens on typical middle-income families are falling.

- A Treasury Department analysis shows that a median-income family of four with two children will pay 7.5 percent of income in federal individual income tax in 1999, a smaller percentage than in any year since 1965.

- In 1999, a median-income family of four will pay *37 percent less* in federal income taxes than a similar family would have paid in 1981. The family will pay 20 percent less than it would have in 1989.

Nor have recent tax reductions been limited to middle-income families or families with children. Higher-income taxpayers are benefitting from a cut in the maximum tax rate on capital gains income from 28 percent to 20 percent. While capital gains income is soaring, most dollars earned in the stock market are being taxed at lower rates. In fact, CBO data show that the percentage of income paid in federal taxes was lower for every income quintile (i.e., each fifth of the income distribution) in 1999 than in 1995.

A variety of other federal tax reductions enacted in 1997 will show up as lower tax burdens in future years; a number of the provisions in that legislation phase in over a period of years. The Joint Tax Committee projected at the time the legislation was enacted that tax reductions under the Taxpayer Relief Act of 1997 will grow from $9.9 billion in fiscal year 1999 to $35 billion in 2003 and $41.6 billion in 2007.

Substantial reductions in state taxes also have been enacted in recent years. Since 1994, 33 states have enacted significant net tax reductions; seven states have enacted net tax increases. Some 34 states — about five-sixths of those with state income taxes — have enacted significant personal income tax cuts in the past six years. Moreover, 29 states have enacted tax cuts that are taking effect in years after 1999, further reducing taxes in future years.

Endnotes

1.The federal taxes that the CBO analysis includes are individual income taxes, employer and employee shares of payroll taxes, excise taxes, and corporate income taxes. Taxes are for families in the middle quintile of the income distribution, with average income of $39,000 in 1999. The federal taxes the JCT analysis includes are individual income taxes (including the outlay portion of the EITC) employer and employee shares of payroll taxes, and excise taxes. Taxes are for families with income between $30,000 and $40,000. State and local taxes are from the National Income and Product Accounts and include personal taxes, corporate profits tax accruals, and indirect business taxes. The rate shown is an average tax rate — taxes as a percent of Net National Product — for 1999. State and local taxes as a percent of Net National Product for 2001 is our own projection.

CBO defines pre-tax family income as the sum of wages, salaries, self-employment income, rents, taxable and non-taxable interest, dividends, realized capital gains, and all cash transfer payments. Income also includes the employer share of Social Security and federal unemployment insurance payroll taxes, and the corporate income tax. For purposes of placing families into quintiles, CBO adjusts for family size; it divides the income for each family by the poverty threshold for a family of that size. The Joint Committee defines income as adjusted gross income (AGI) plus tax-exempt interest, employer contributions for health plans and life insurance, the employer share of Social Security, worker's compensation, nontaxable Social Security benefits, the insurance value of Medicare benefits, alternative minimum tax preference items, and excluded income of U.S. citizens living abroad.

2.*The Estimates of Federal Tax Liabilities for Individuals and Families by Income Category and Family Type for 1995 and 1999.* CBO Memorandum, May, 1998. The data shown here are the CBO data for average federal taxes paid by families in the middle quintile (i.e., the middle fifth) of the income distribution. The $39,000 figure cited here is the CBO estimate of the average income of families in the middle quintile of the income distribution. Data were updated with the CBO memorandum, "Preliminary Estimates of Effective Tax Rates," June 15, 1999. The CBO data show that the share of income paid in federal taxes by the other four-fifths of the population also was lower in 1999 than in 1995.

3.*Distributional Effects of the "Marriage Tax Relief Reconciliation Act of 2000"* (JCX-80-00), July 20, 2000 and *Distributional Effects of the Revenue Reconciliation Provisions of H.R. 2491 As Agreed to by the Conferees* (#D-95-79), November 14, 1995.

4.U.S. Department of Commerce, Bureau of Economic Analysis, National Accounts Data, various years.

5.Jane G. Gravelle, *Capital Gains Taxes: Distributional Effects*, Congressional Research Service, September 24, 1999.

6.June E. O'Neill, *The Economic and Budget Outlook: Fiscal Years 1999-2008*, Testimony before the Senate Budget Committee, January 28, 1998.

7.Lawrence B. Lindsey, *Federal Tax Policy*, testimony before the Senate Budget Committee, January 20, 1999.

8.Testimony before the Senate Budget Committee, January 28, 1999.

9.Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010*, January 2000, pp. 52-56. CBO notes that most of the increase in capital gains taxes occurred before the cut in capital gains tax rates in 1997.