TAX FOUNDATION FIGURES DO NOT REPRESENT MIDDLE-INCOME TAX BURDENS

by Joel Friedman, Andrew Lee, and Isaac Shapiro

The Tax Foundation today 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 far lower taxes as a share of their income than the Tax Foundation's report implies.

The Tax Foundation routinely shows significantly higher tax burdens than those authoritative, nonpartisan sources find middle-income taxpayers actually bear. For example:

- The new Tax Foundation report claims that federal taxes will equal 20.3 percent of income in 2003.
- By contrast, the Joint Committee on Taxation has estimated that the federal tax burden in 2003 on families in the middle of the income spectrum will equal 14.8 percent of income. Our update of a Congressional Budget Office analysis finds such families will pay 15.8 percent of income in federal taxes in 2003.
- The Tax Foundation implies that typical or average middle-income taxpayers pay about 28 percent more in federal taxes than is actually the case.

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.

Share of Income for Federal Taxes

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<tr>
<td>CBO (middle fifth)</td>
<td>17.6%</td>
<td>17.5%</td>
<td>17.2%</td>
<td>15.8%</td>
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<td>JCT ($30,000-$40,000)</td>
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<td>16.3%</td>
<td>14.8%</td>
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<td>Tax Foundation (average)</td>
<td>20.8%</td>
<td>21.8%</td>
<td>23.1%</td>
<td>20.3%</td>
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*The CBO figures for 2000 to 2003 reflect updates by the authors. The JCT figures come from its latest distributional analysis, which was conducted in 2001.
The Problems with the Methodology

In computing what it says are average tax burdens, the Tax Foundation uses a measure of tax receipts as a percentage of the economy. The Tax Foundation divides total tax receipts by an estimate of the total amount of income in the nation. This method suffers from the following fundamental 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" are said to pay look considerably larger than they actually are.

Suppose four families with incomes of $25,000 each pay $1,250 in income tax — five percent of their income — while one wealthy family with $400,000 in income pays $100,000 in income tax, or 25 percent of its income. If one averages these figures, one finds that 21 percent of the total income of these five families goes to pay federal income taxes. (Dividing these families' total tax payments of $105,000 by their total income of $500,000 shows that 21 percent of their total income is paid in taxes.)

Under the Tax Foundation methodology, this 21 percent figure would then be used to say that the average family in this group pays 21 percent of income in income taxes and must work until 21 percent of the year has passed to pay its income tax. Yet the 21 percent figure is a misleading indication of the typical tax burden of families in this group. The four moderate-income families pay five percent of their income in income tax, less than one-quarter of the average 21 percent rate. Using averages in this fashion when talking about tax burdens, as the Tax Foundation does, produces skewed results; it essentially ascribes to the average taxpayer the tax rates that only people at considerably higher income levels pay.

Taxes counted, but taxed income not counted

Exacerbating this problem, the Tax Foundation methodology fails to provide an accurate representation of the average tax rate for the nation as a whole. 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, 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 measure of income that also omits capital gains.) Counting capital gains taxes as part of tax receipts while failing to count capital gains income as part of income distorts — and inflates — average tax rates. Despite Chairman Greenspan's...
warning that "you can't use" this measure, an admonition other tax experts have made in the past, the Tax Foundation repeats this mistake 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 optional Medicare premiums that older Americans 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.

**Divergence between Tax Foundation and authoritative sources is substantial**

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. The Joint Committee on Taxation information and the updated Congressional Budget Office information shown in the earlier table indicate that tax burdens on typical middle-income families are considerably lower than the Tax Foundation reports suggest. In 2003, our update of the CBO figures finds that the federal tax rate for the middle fifth of families will be 15.8 percent. Relative to this figure, the 20.3 percent estimate cited by the Tax Foundation overstates the burden by about 28 percent. The gap between the Joint Tax Committee's estimate and the Tax Foundation's estimates is even larger.

Moreover, a soon-to-be-released analysis by the Center on Budget and Policy Priorities finds that in 2002 and 2003 the overall federal tax rates for the middle fifth of households will be at their lowest levels on record, with data back to 1979. In addition, their *income* tax rate is at the lowest level since 1957.

**The Tax Foundation's state-by-state data are similarly 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. Since the Tax Foundation methodology substantially overstates the federal tax burden of middle-income families, the Tax Freedom Day figures for each state also are exaggerated.

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\(^1\) 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 a typical household's tax burden.