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RECENT TAX AND INCOME TRENDS AMONG HIGH-INCOME TAXPAYERS

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Administration officials have consistently sought to portray the distribution of benefits from the 2001 and 2003 tax cuts as balanced or even progressive. Recently, for example, the Treasury Department released a “Tax Relief Kit,” which includes a fact sheet entitled “Who Pays Most Individual Income Taxes?” 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 the burden these taxpayers bear has *increased* as a result of the tax cuts enacted under the Bush Administration.¹

These Administration claims are designed to counter arguments that the tax cuts enacted since 2001 are tilted to those at the top of the income scale. The claims, however, are misleading. By focusing only on the federal income tax and leaving out all other federal taxes, they misrepresent both the degree to which the tax code is progressive and who is benefiting the most from the recent tax cuts.

- **While the nation’s tax code is progressive, it is not nearly as progressive as the statistics highlighted by the Administration might lead one to believe.** The Treasury analysis shows that the one percent of taxpayers with the highest incomes paid 34.3 percent of federal individual income taxes in 2003. However, an analysis by the Congressional Budget Office shows that this group paid a substantially smaller proportion — 22.6 percent — of total federal taxes, including payroll, excise, and other taxes.² The progressivity of the tax system is further muted if state and local taxes are considered. When these taxes are taken into account, the share of total taxes groups pay becomes more similar to their share of total income, meaning that the tax system as a whole is only mildly progressive.
- **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 about \$39,000 in 2006, according to data from the Urban Institute-Brookings Institution Tax Policy Center, or 52 times the average tax cut that the middle fifth of

¹ Treasury Department, “Tax Relief Kit,” March 2006.

² Congressional Budget Office, “Historical Effective Federal Tax Rates, 1979-2003,” December 2005. Unless otherwise noted, all the CBO data mentioned in this analysis come from this report.

taxpayers will receive. The highest-income taxpayers also are experiencing a much greater percentage increase in after-tax income as a result of the tax cuts than other taxpayers. Finally, other 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 than they would be paying in the absence of these tax cuts.

- **Although high-income households paid a larger share of federal taxes in 2003 than in 1990, their after-tax incomes increased much faster over this period than those of any other income group.** The CBO data show that from 1990 to 2003 — the period that the Treasury fact sheet covers — the average after-tax income of the top one percent of the population jumped 35 percent, while the average after-tax income of the middle fifth of the population rose 12 percent. When the 1980s are included, this differential is even larger. It should be noted that a significant part of the increase in the share of taxes that is paid by high-income households simply reflects the large rise in their share of the total income in the nation.
- **The tax burden on high-income households is not high in historical terms.** Even though high-income taxpayers pay a significant share of federal taxes, their actual tax burdens — the percentage of income that 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 2003 than they paid in any year since 1992. The percentage of income that these households paid in federal taxes dropped significantly between 2002 and 2003, as tax cuts from which they benefit — such as the reduction in the top income tax rates and the cut in capital gains and dividend tax rates — took 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.³ The payroll tax places a greater burden on low- and middle-income families than the income tax because it is levied at a flat rate on the first dollar of wages and does not apply to wages above \$94,200 in 2006. 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.⁴

³ CBO estimates that in 2006, individual income taxes will represent 43 percent of all federal taxes, and payroll taxes will represent 36 percent. After 2006, the share attributable to individual income taxes is projected to rise somewhat and the share attributable to payroll taxes to fall modestly.

⁴ Congressional Budget Office, "Effective Federal Tax Rates, 1979-2000," August 2003. The CBO 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 22.6 percent of all federal taxes in 2003, significantly below the 34.6 percent share of individual *income* taxes that CBO estimates this group paid.⁵

The CBO data also indicate that in 2003, the top one percent of households received 14.3 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 that Administration claims imply.

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 that the noted tax expert Joseph Pechman demonstrated nearly two decades ago.

Estimates by the Citizens for Tax Justice confirm this conclusion. They show that in 2004, the overall share of federal, state, and local taxes combined that high-income households paid was 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 was just a little more than one percentage point lower than their share of the national income, according to the CTJ estimates.⁶ 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 2006, with nearly all 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. But the assertion that the Administration’s tax cuts have made the tax code more progressive does not hold up under scrutiny.

Administration Assertions Ignore More Relevant Data

Data from the Congressional Budget Office (which are described in a September 2004 Center analysis and available on the CBO website) and data from the Urban Institute-Brookings Institution Tax Policy Center indicate that the tax cuts enacted since 2001 are benefiting high-income

⁵ The CBO estimate (34.6 percent) is slightly higher than the Treasury estimate (34.3 percent). This small discrepancy exists largely because the two institutions employ somewhat different concepts of income and of the populations that their analyses cover.

⁶ 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 U.S. population covered in its analysis that are somewhat different than those used by CBO and Treasury.

households the most and exacerbating the concentration of after-tax income at the top of the income scale. Data from the Tax Policy Center show that in 2006:

Table 1: Impact of Enacted Tax Cuts, 2006		
Income Class	Average Tax Cut	Percentage Change in After-Tax Income
Middle 20 percent	\$748	2.5%
Top one percent	\$39,020	5.0%
Over \$1 million	\$111,549	5.7%
Source: Urban-Brookings Tax Policy Center		

- High-income households will experience a larger increase in after-tax income as a result of the tax cuts than any other income group. The average after-tax income of the top one percent of households will grow by 5 percent in 2006 as a result of the tax cuts, twice the percentage increase in after-tax income that will be experienced by the 20 percent of households in the middle of the income spectrum. Tax filers with incomes of more than \$1 million will see their after-tax income grow even more, by 5.7 percent, as a result of the tax cuts. The tax cuts thus have made the distribution of after-tax income more unequal.
- Not surprisingly, high-income households are receiving the largest dollar tax cuts, by far, of any group. Those in the top one percent of the income spectrum will receive an average tax cut of \$39,000 in 2006, or 52 times as much as households in the middle of the income spectrum. Those with incomes of over \$1 million will receive an average tax cut of more than \$111,000, or nearly 150 times the average tax cut that middle-income households will receive.
- The top 20 percent of households is the only group whose share of the tax-cut benefits is larger than its share of total national income. These households will receive 69.6 percent of the tax-cut benefits in 2005, but will have 60.3 percent of the nation's income (before taxes are factored in).

As the preceding discussion indicates, there is a range of statistics available to assess the impact of tax cuts on different income groups. Economists generally believe that examining how tax cuts alter the “after-tax” income of households is the most appropriate measure of the distributional impact of tax cuts, since this measure can show whether a tax change has increased or remedied gaps in the distribution of income. After-tax income represents the best measure of the income that a household has available to spend or save. (See the box on page 6 for a discussion of the likely impact of the tax cuts on different income groups when measures are instituted, as they eventually will have to be, to pay for the tax cuts.)

By contrast, the Administration tends to focus on the share of taxes paid by different income groups. As noted, the Administration's preferred statistic tells us that the higher-income group paid a slightly larger share of the much smaller amount of federal income taxes that were collected after the tax cuts. This statistic is not particularly meaningful, however, for assessing the distribution of the tax cuts.

The flaw in the Administration's favored statistic can be seen by taking the Administration's case to its logical extreme. Assume, for instance, that all taxes were eliminated except that high-income households had to pay taxes equal to \$1 a year. The high-income group would be paying 100

percent of all taxes. Under the Administration's logic, the tax code would be much more progressive as a result of this change, because those at the top would be paying 100 percent of the taxes. Yet this statistic would have little meaning because the revenue base would have essentially been eliminated.

While not to this extreme, the revenue base is in fact eroding, in substantial part due to the tax cuts. Federal revenues have fallen below their historical average. In 2006, CBO estimates that federal revenues will equal 17.7 percent of the Gross Domestic Product, a level lower than the average levels for the decades of the 1960s, 1970s, 1980s, and 1990s.

The "tax shares" measure is also distorted by increasing inequality in before-tax incomes. One would expect the tax share of high-income households to rise when their share of total before-tax income in the nation increases. A substantial part of the increase in the top one percent's share of income taxes between 1990 and 2003 is simply due to this increase in income inequality (see discussion below).

Administration Focus on 2006 Leaves Out Tax Cuts

By focusing on 2006, the Treasury fact sheet leaves out tax cuts that are not yet in full effect and that benefit only the wealthiest households. The Treasury figures are not representative of the impact of the full range of the tax cuts that were enacted in 2001 and 2003 and that the Administration is seeking to make permanent.

- The estate tax changes enacted in 2001 only take effect gradually, with full repeal not occurring until 2010. Even prior to enactment of these changes, the IRS reports that the estate tax affected only the wealthiest two percent of people who died each year. In 2006, the estate tax cuts are relatively modest compared to the huge benefits that wealthy households will receive when the tax is repealed.
- Two tax cuts enacted in 2001 have only begun to take effect in 2006. When they take full effect, these two tax-cut measures, which benefit only high-income households, will provide taxpayers with incomes exceeding \$1 million with additional tax reductions of \$19,000 annually. (The two tax-cut measures repeal provisions of current law that phase down or phase out the benefits of personal exemptions and some itemized deductions for high-income taxpayers; they begin to take effect in 2006 but will not be fully in effect until 2010.)
- Tax Policy Center estimates show that when all of the tax cuts enacted in 2001 and 2003 are fully in effect, households in the top one percent of the income spectrum will pay a slightly smaller share of federal taxes than they would pay in the absence of the tax cuts, not a larger share.

Income Gains Have Been Much More Rapid at the Top, Even After the Effects of Taxes Are Taken into Account

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

Assessing the Tax Cuts Along with Options to Pay for Them

The estimates of the distributional impact of the tax cuts discussed in this report reflect only the “benefit” side of the equation, ignoring the impact of the steps that ultimately will have to be taken to cover the costs of the tax cuts. Yet an assessment of the effects of the tax cuts, particularly over the long term, is incomplete if it does not take into account the estimated impact of measures that ultimately will have to be taken to pay for the tax cuts.

This is especially true of efforts to assess the impact of proposals to make the tax cuts permanent, because those impacts will unfold over a period in which the nation’s underlying fiscal position (even without the tax cuts) will be sharply out of balance due to the retirement of the baby-boom generation. As a result, the cost of the tax cuts eventually will have to be offset.

To date, the tax cuts have been financed by higher deficits and increased borrowing. Borrowing postpones, but does not eliminate, the need to pay for the tax cuts. Paying for the tax cuts ultimately will require reductions in federal programs, increases in federal taxes, or some combination of the two.

The precise mix of program cuts and tax increases that ultimately will be adopted to offset the costs of the tax cuts is not known. The Tax Policy Center has, however, examined two possible scenarios. Under one scenario, each household will pay the same dollar amount to offset the cost of the tax cuts (roughly this scenario could occur if the tax cuts were financed largely or entirely through cuts in federal programs). Under the other scenario, each household pays the same percentage of its income to cover the costs of the tax cuts. (This is consistent with a financing scenario that combines program cuts and progressive tax increases.)

The Tax Policy Center found that, under either scenario, *more than three-quarters of households* would not benefit from the tax cuts and would end up losing *more* than they gain. Only those with high incomes would be better off. This result — that the majority of households would be net losers — reflects the fact that the bulk of the tax cuts are going to households with high incomes and that unless the measures ultimately adopted to cover the costs of the tax cuts are aimed at high-income households to the same degree that the tax cuts benefit those households, the net effects will be negative for the majority of Americans.

In their analysis of the Bush tax cuts, Brookings Institution economists and Tax Policy Center co-directors William Gale and Peter Orszag write that their preferred measure to use in assessing the distributional effects of tax changes is the change in after-tax income, after accounting for the financing of the tax cuts. They point out that a distributional analysis of the 2001 and 2003 tax cuts that does not include the impact of financing may yield seemingly contradictory evidence, but that once the financing is included in the analysis, the “the apparent contradictions are removed, and all of the measures show that the tax cuts are regressive.”*

*William Gale and Peter Orszag, “Bush Administration Tax Policy: Distributional Effects,” Tax Notes, September 27, 2004.

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 129 percent — more than doubling — between 1979 and 2003. In contrast, the incomes of those in the middle fifth of the income spectrum grew by an average of 15 percent over this period, or just 0.6 percent a year.⁷ In dollar terms, the top one percent experienced a \$395,700 average increase in after-tax income over this period, while those in the middle saw their incomes grow by an average of \$5,900. (These figures are adjusted to remove the effects of inflation. The CBO data cover the years from 1979 through 2003.)

Table 2: Growth in After-Tax Income				
Income Class	1990-2003		1979-2003	
	Percentage Increase	Increase in Dollars	Percentage Increase	Increase in Dollars
Middle 20 Percent	12.3%	\$4,900	15.2%	\$5,900
Top One Percent	34.9%	\$181,500	129.4%	\$395,700
Source: Congressional Budget Office. Figures are adjusted for 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 2003 than among ordinary households. According to the CBO data:

- Between 1990 and 2003, the average after-tax income of the top one percent of households rose from \$520,000 to \$701,500. This represents a robust average gain of \$181,500 per household, or 35 percent.
- Middle-income households gained much more modestly over this period. The average after-tax income of the middle fifth of households rose by \$4,900, or 12 percent between 1990 and 2003.

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 increased substantially over this period. According to CBO, the top one percent received 12.2 percent of the nation's after-tax income in 2003, up sharply from this group's 7.5 percent share in 1979.⁸

⁷ These trends parallel the changes in *before-tax* incomes. The CBO data show that the before-tax income of the top one percent of the population grew by 111 percent between 1979 and 2003. In contrast, the before-tax incomes of those in the middle fifth of the income scale grew by 9 percent over this period. Among both groups, after-tax incomes grew at a somewhat more rapid rate than before-tax incomes due to the general decline in the rate of taxation.

⁸ The share of income going to the top one percent was lower in 2003 than in the years from 1997 through 2001, reflecting the drop in the stock market. The CBO data now end in 2003. Since 2003, however, income gains at the top may have outpaced the gains across the rest of the income spectrum, as the stock market recovered. For instance, census data show that the top five percent of households experienced income gains from 2003 to 2004 while other households did not. In fact, most other households saw their incomes decline from 2003 to 2004, after adjusting for inflation.

Similarly, the top 20 percent received almost as much income in 2003 as the bottom 80 percent of the population. That is, the 23 million households with the highest incomes (the top 20 percent) received about as much income as the bottom 89 million households combined.

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

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 2003 than in a number of the previous years covered by the CBO study.

- CBO estimates that in 2003, the top one percent of households paid an average of 31.4 percent of their income in federal taxes, including income, payroll, and other taxes.
- This percentage is lower than in any year since 1992.
- The percentage also is lower than in 1979, 1980, and 1981, 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.

The percentage of income paid in taxes by the top one percent of households fell by almost one and one-half percentage points just between 2002 and 2003, reflecting the tax cuts enacted in 2003. The income tax rate reductions enacted in 2001 were accelerated in 2003, and tax cuts on dividend and capital gains income were instituted. As noted above, high-income households will benefit from further tax reductions in future years as estate tax and other tax cuts take full effect.

Conclusion

The Administration has made selective use of statistics to create dubious impressions about the nature of the nation's tax burden and the impact of the tax cuts enacted since 2001. In general, the overall U.S. 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 much more rapidly than everyone else's and they now receive a larger share of the national income. These trends continue to hold after the effects of taxes are taken into consideration.

Moreover, the percentage of income that high-income households pay in federal taxes has been declining since 1996 and was lower in 2003 (the last year for which these data are available) than in any year since 1992. High-income households also will benefit to a far greater degree than other households from the additional tax cuts that will take effect over the next few years, as the tax cuts enacted in 2001 continue phasing in.