



CENTER ON BUDGET AND POLICY PRIORITIES

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TAX FOUNDATION FIGURES DO NOT REPRESENT MIDDLE-INCOME TAX BURDENS

Figures May Mislead Policymakers, Journalists and the Public

by Joel Friedman, David Kamin, and Robert Greenstein

Each year shortly before April 15, the Tax Foundation releases a report projecting "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 report as reflecting 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 significantly less in taxes as a share of their income than the Tax Foundation's report implies.*

Highlights

- The Tax Foundation employs averages in a misleading fashion that overstates the tax burdens of the vast majority of families. Analysis by authoritative institutions such as the Congressional Budget Office shows most Americans pay significantly less in taxes than the Tax Foundation reports.
- In figuring the percentage of income that U.S. families as a whole pay in taxes, the Tax Foundation counts taxes paid on capital gains but ignores the capital gains income on which these taxes are paid. This approach, which Alan Greenspan has said is invalid, artificially inflates the percentage of income consumed by taxes.
- The Tax Foundation analysis also counts as taxes certain *non-tax* items, like the premiums that older American can elect to pay for Medicare Part B, intra-governmental transfers, and rents that individuals or businesses pay to rent property that state or local governments own. This further inflates tax burdens.

The Tax Foundation's annual Tax Freedom Day reports consistently show significantly higher tax burdens than those that authoritative, nonpartisan sources find middle-income taxpayers actually bear. This can be seen by comparing the Tax Foundation estimates of tax burdens to Congressional Budget Office estimates. As the table on the following page shows, CBO's estimates of the share of income that the middle fifth of American households pay in federal taxes have consistently been well below the levels of taxation that the Tax Foundation reports suggest "average" Americans pay.

- The most recent CBO estimates cover years through 2002. In that year, CBO found that that the middle fifth of households — those in the middle of the income spectrum — paid 14.4 percent of their income in federal taxes. In contrast, in its report from last

year, the Tax Foundation estimated that the “average” American paid 19.7 percent of income in federal taxes in 2002.

Percentage of Income Paid in Federal Taxes				
	<u>1998</u>	<u>2000</u>	<u>2002</u>	<u>2004</u>
Congressional Budget Office (middle fifth of households)	16.8%	16.6%	14.4%	14.0%*
Tax Foundation (average)	22.4%	23.1%	19.7%	17.9%
*The 2004 estimate is made by CBPP based on CBO data; CBO estimates for 1998-2002 are from “Historical Effective Federal Tax Rate: 1979 to 2002,” March 2005.				

- In its report last year, the Tax Foundation estimated that federal taxes will consume an average of 17.9 percent of the income of Americans in 2004. Even though this estimate represents the lowest average tax burden since 1949, according to the Tax Foundation, it is still higher than what CBO found the middle fifth of households paid in federal taxes as a percentage of their income *in 2000, before the Bush tax cuts were enacted*. Our update of the CBO estimate indicates that the middle fifth of households paid about 14 percent of their income in federal taxes in 2004.

The Tax Foundation’s conclusions about federal tax burdens conflict with CBO findings because the Tax Foundation uses a seriously flawed methodology. This methodology distorts — and inflates — tax burdens. The Tax Foundation’s estimates of *state* tax burdens are similarly flawed in inflated (see box on page 4).¹

The Problems with the Methodology

In computing what it says is “the average American tax burden,” the Tax Foundation divides what it says is total tax receipts by what it says is the total amount of income in the nation. The Tax Foundation method suffers from the following problems.

Average Tax Figure is Misleading

Under our progressive tax system, high-income taxpayers pay significantly larger 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 pay look considerably larger than they actually are.

Suppose four families with incomes of \$50,000 each pay \$2,500 in income tax — five percent of their income — while one wealthy family with \$400,000 in income pays \$80,000 in income tax, or 20 percent of its income. If one averages these figures, one finds that 15 percent of the total income of these five families goes to pay federal income taxes. (Dividing the families' total tax payments of

¹ See Iris Lav, Joseph Llobrera, and Nicholas Johnson, “Tax Foundation Estimates of State and Local Tax Burdens Are Not Reliable,” Center on Budget and Policy Priorities, April 7, 2005.

Greenspan Warns Against Seriously Flawed Approach Tax Foundation Uses

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 the Gross Domestic Product (or a similar measure), to determine the overall average tax rate (i.e., to determine the percentage of total income in the nation that is paid in taxes) — is not valid. Greenspan flatly stated: "you can't use tax receipts over nominal GDP as a tax rate."

Chairman Greenspan explained one reason that 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 a closely related Commerce Department income measure — NNP, or Net National Product — that also omits capital gains income. Counting capital gains taxes as part of tax receipts while failing to count as income the capital gains income on which these taxes are paid distorts — and inflates — average tax rates.

In its report last year, the Tax Foundation attempted to respond to such criticism. It asserted that the NNP measure "fully accounts for capital gains." This claim is flatly false. As the Bureau of Economic Analysis at the Commerce Department confirms, NNP does *not* include capital gains income.

\$90,000 by their total income of \$600,000 shows that 15 percent of their total income is paid in income taxes.)

Under the Tax Foundation methodology, this 15 percent figure would be used to say or imply that the average family in this group pays 15 percent of its income in income taxes and must work until 15 percent of the year has passed to pay its income tax bill. Yet the 15 percent figure is highly misleading as an indicator of the typical tax burden of families in this group. The four moderate-income families in the group pay five percent of their income in income tax, or one-third of the average 15 percent rate. Using averages in this fashion when talking about tax burdens, as the Tax Foundation does, produces skewed results; it essentially ascribes to average taxpayers the tax rates that only people at considerably higher income levels pay.

Taxes Counted, but Taxed Income *Not* Counted

Making the problem worse, the Tax Foundation methodology fails even to provide an accurate representation of the average tax rate for the nation as a whole. In 2002, Alan Greenspan declared in a Congressional hearing in 2002 that the type of approach the Tax Foundation uses is not valid (the box above explains why, as Chairman Greenspan stated, the Tax Foundation approach is invalid). Despite Chairman Greenspan's warning that "you can't use" this measure, an admonition that other tax experts also have made in the past, the Tax Foundation has repeated this error every year.²

² One should note that taxes as a percentage of GDP can offer some meaningful insights; for instance, it provides a sense of the share of the economy devoted to the public sector. But this calculation is inappropriate and misleading as a description of average households' tax burdens.

The Tax Foundation's State-by-State Data Also are Seriously Flawed

In past years, the Tax Foundation's reports also have included a list of the dates described as representing "Tax Freedom Day" for each state. The serious flaws that mar the Tax Foundation's estimates of tax burdens nationally plague its state-by-state estimates and make them invalid as well.*

- About two-thirds of the tax burdens in the Tax Foundation calculations are federal tax burdens. The amount of federal taxes paid by the residents of a state thus has a large impact on that state's "Tax Freedom Day." Since, as this analysis explains, the Tax Foundation methodology substantially overstates the federal tax burden of middle-class families, the Tax-Freedom-Day figures for each state also substantially exaggerate the tax burdens of middle-class families.
- Because the federal income tax system is progressive, states with relatively wealthy residents end up under the Tax Foundation's methodology with a higher federal tax burden than other states. The fact that one state has higher-income residents than another state has nothing to do with the level of *state and local* taxes in the state. Yet by trumpeting state-level Tax Freedom Days that differ across the states, the Tax Foundation misleadingly implies that differences in burdens imposed by state and local taxes account for the differences across states in the Tax Foundation's "average tax burden."
- The Tax Foundation uses a procedure to allocate state corporate and severance taxes based on the residence of the consumers who purchase products that businesses sell (adjusted for taxes that tourists pay). This is likely to lead to further misimpressions about the role of a state's tax policies on the tax burdens its residents are said to face. For example, when Alaska collects taxes from oil companies based on the amount of oil they produce in the state, the Tax Foundation does not count those taxes as part of Alaska's revenue. Rather, they add those taxes to the tax burden in the states where oil is consumed. Maine residents, for example, consume a significant amount of fuel and so get allocated a large share of these Alaska taxes. Yet state legislators in Maine cannot have much impact on the level of taxes that Alaska or other oil-producing states levy on oil.

Further, the Tax Foundation highlights the tax burden for the current calendar year, making its own estimates of the taxes that will be collected during the year in the thousands of state and local jurisdictions around the country. Despite presenting these estimates as definitive, they are in fact speculative projections that are often proven wrong when the actual data on state and local taxes are subsequently collected and published by the Census Bureau. For example, the Tax Foundation's 2002 report claimed that tax burdens had risen since 2000 in 38 states, while five states had lower tax burdens and seven had no change. By 2004, the Tax Foundation had revised its 2002 estimates to show that only nine states had higher tax burdens in 2002 than in 2000, while 38 had lower tax burdens and three had no change. When the Census Bureau released its data for 2002, it found that only four states' tax burdens had risen, while in 43 states tax burdens had fallen (burdens were unchanged in three states). In its reports, the Tax Foundation does not acknowledge the possibility that its data may be erroneous. Nor does it give prominent attention to the revisions it makes in subsequent years when its previous estimates prove to have been faulty.

As a result, the Tax Foundation's proclamations of state Tax Freedom Days are misleading and do little to inform legitimate debates over levels of state and local taxes and the services those taxes support.

* See Iris Lav, Joseph Llobrera, and Nicholas Johnson, "Tax Foundation Estimates of State and Local Tax Burdens Are Not Reliable," Center on Budget and Policy Priorities, April 7, 2005.

Non-Tax Items Are Counted As Taxes

The Tax Foundation also counts as taxes certain items that are *not* taxes. These include Medicare premiums that older Americans elect to 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.

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, such as the Congressional Budget Office and the Urban Institute-Brookings Institution Tax Policy Center.

Tax Levels versus Expenditures on Food, Clothing and Medical Care

Finally, the Tax Foundation claims that families must pay more in taxes than they pay for food, clothing, and medical care combined. This Tax Foundation claim, which apparently compares total tax payments in the nation to total food, clothing, and medical care expenditures, is likely to create further misimpressions.

If the statement that total tax payments exceed total expenditures for food, clothing and medical care is accurate (one cannot determine the accuracy of this assertion based on information that the Tax Foundation has provided in its reports), this tells us little about the relationship between taxes and spending for families in the middle of the income scale. It is no doubt true that upper-income families pay more in taxes than they spend for these items. It also is true that low- and moderate-income families pay significantly *less* in taxes than they spend for such items; necessities consume most of their income. The precise family income level at which taxes typically exceed expenditures for food, clothing and medical care is unclear. In the past, the Tax Foundation has failed to provide any information on that matter.