The American

Guess Who Really Pays the Taxes

By Stephen Moore From the November/December 2007 Issue

Yes, income in America is skewed toward the rich. But taxes are skewed far, far more. The top 5 percent pay well over half the income taxes. STEPHEN MOORE has the numbers.

1. Are income taxes fair?

That depends on who is offering the opinion. Democratic candidates for president certainly don't think so. John Edwards has said, "It's time to restore fairness to a tax code that has been driven badly out of whack." Hillary Clinton laments that "middle-class and working families are paying a much higher percentage of their income [in taxes]." Over the past seven years, however, Americans in general think taxes have become *more* fair, not less. The Gallup Organization found in an April poll that 60 percent of respondents believe the income taxes that they themselves pay are fair, compared with 37 percent who believe the taxes they pay are unfair. In 1997, the figures were 51 percent fair and 43 percent unfair.

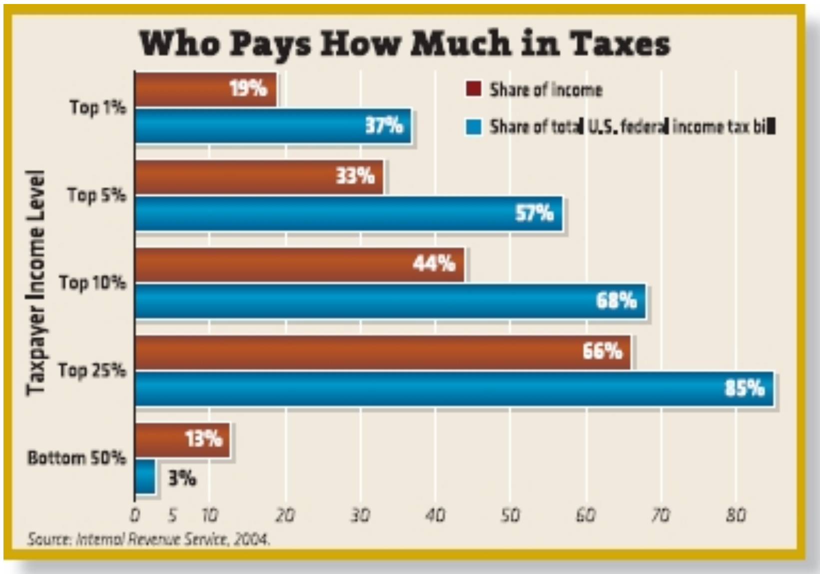
2. What income group pays the most federal income taxes today?

The latest data show that a big portion of the federal income tax burden is shouldered by a small group of the very richest Americans. The wealthiest 1 percent of the population earn 19 percent of the income but pay 37 percent of the income tax. The top 10 percent pay 68 percent of the tab. Meanwhile, the bottom 50 percent—those below the median income level—now earn 13 percent of the income but pay just 3 percent of the taxes. These are proportions of the income tax alone and don't include payroll taxes for Social Security and Medicare.

3. But didn't the Bush tax cuts favor the rich?

The New York Times reported recently that the average family in America with an income of $10 million or more received a half-million-dollar tax cut, while the middle class got crumbs (less than $100 shaved off their tax bill). If we examine the taxes paid in a static world—that is, if we assume that there was no change in behavior and economic performance as a result of the tax code—then these numbers are meaningful. Most of the tax cuts went to the super wealthy.

But Americans *did* respond to the tax cuts. There was more investment, more hiring by businesses, and a stronger stock market. When we compare the taxes paid under the old system with those paid after the Bush tax cuts, the rich are now actually paying a higher proportion of income taxes. The latest IRS data show an increase of more than $100 billion in tax payments from the wealthy by 2005 alone. The number of tax filers who claimed taxable income of more than $1 million increased from approximately 180,000 in 2003 to over 300,000 in 2005. The total taxes paid by these millionaire households rose by about 80 percent in two years, from $132 billion to $236 billion.



4. But haven't the tax cuts put more of the burden on the backs of the middle class and the poor?

No. I examined the Treasury Department analysis of how much the rich would have paid without the Bush tax cuts and how much they actually did pay. The rich are now paying more than they would have paid, not less, after the Bush investment tax cuts. For example, the Treasury's estimate was that the top 1 percent of earners would pay 31 percent of taxes if the Bush cuts did not go into effect; with the cuts, they actually paid 37 percent. Similarly, the share of the top 10 percent of earners was estimated at 63 percent without the cuts; they actually paid 68 percent.

5. What has happened to tax rates in America over the last several decades?

They've fallen. In the early 1960s, the highest marginal income tax rate was a stunning 91 percent. That top rate fell to 70 percent after the Kennedy-Johnson tax cuts and remained there until 1981. Then Ronald Reagan slashed it to 50 percent and ultimately to 28 percent after the 1986 Tax Reform Act. Although the federal tax rate fell by more than half, total tax receipts in the 1980s doubled from $517 billion in 1981 to $1,030 billion in 1990. The top tax rate rose slightly under George H. W. Bush and then moved to 39.6 percent under Bill Clinton. But under George W. Bush it fell again to 35 percent. So what's striking is that, even as tax rates have fallen by half over the past quarter-century, taxes paid by the wealthy have increased. Lower tax rates have made the tax system more progressive, not less so. In 1980, for example, the top 5 percent of income earners paid only 37 percent of all income taxes. Today, the top 1 percent pay that proportion, and the top 5 percent pay a whopping 57 percent.

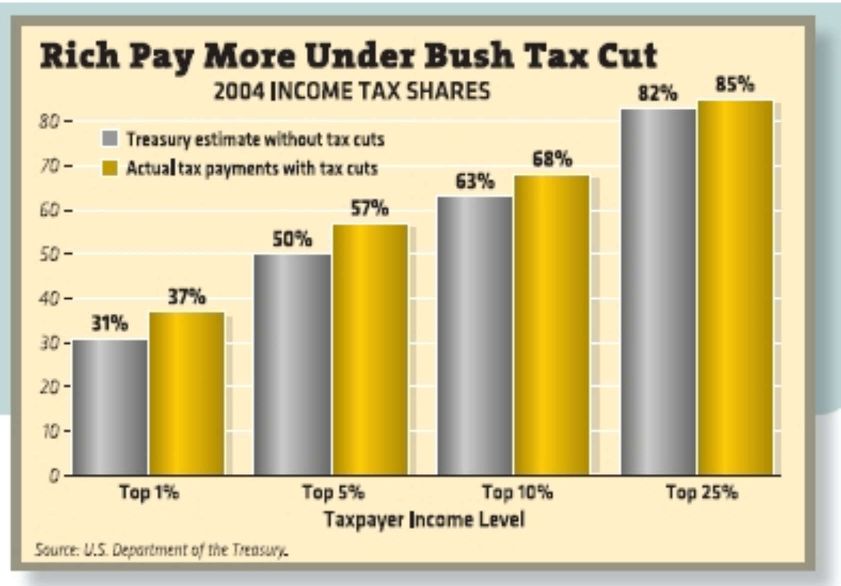
6. What is the economic logic behind these lower tax rates?

As legend has it, the famous "Laffer Curve" was first drawn by economist Arthur Laffer in 1974 on a cocktail napkin at a small dinner meeting attended by the late Wall Street Journal editor Robert Bartley and such high-powered policymakers as Richard Cheney and Donald Rumsfeld. Laffer showed how two different rates—one high and one low—could produce the same revenues, since the higher rate would discourage work and investment. The Laffer Curve helped launch Reaganomics here at home and ignited a frenzy of tax cutting around the globe that continues to this day. It's also one of the simplest concepts in economics: lowering the tax rate on production, work, investment, and risk-taking will spur more of these activities and will often produce more tax revenue rather than less. Since the Reagan tax cuts, the United States has created some 40 million new jobs—more than all of Europe and Japan combined.

7. Are lower tax rates responsible for the big budget deficits of recent decades?

There is no correlation between tax rates and deficits in recent U.S. history. The spike in the federal deficit in the 1980s was caused by massive spending increases.

The Congressional Budget Office reports that, since the 2003 tax cuts, federal revenues have grown by $745 billion—the largest real increase in history over such a short time period. Individual and corporate income tax receipts have jumped by 30 percent in the two years since the tax cuts.



8. Do the rich pay more taxes because they are earning more of the income in America?

Yes. There's no doubt that the share of total income earned by the wealthy has increased steadily over the past 25 years. Since 1980, the share of income earned by the richest 1 percent has more than doubled, from 9 percent to 19 percent. The share of the income going to the poorest income quintile has declined. Income disparities, in absolute dollars, have grown substantially.

What is significant is that for the top 5 percent and 10 percent of earners, the ratio of taxes paid compared with income earned has risen. For example, in 1980, the top 10 percent earned 32 percent of the income and paid 44 percent of the taxes—a ratio of 1.4. In 2004, this group earned more of the income (44 percent) but paid a lot more of the taxes (68 percent)—a ratio of 1.6. In other words, progressivity—in terms of share of total taxes paid—has risen. On the other hand, for the top 1 percent of earners, progressivity has declined from a ratio of 2.2 in 1980 to 1.9 in 2004.

9. Have gains by the rich come at the expense of a declining living standard for the middle class?

No. If Bill Gates suddenly took his tens of billions of dollars and moved to France, income distribution in America would temporarily appear more equitable, even though no one would be better off. Median family income in America between 1980 and 2004 grew by 17 percent. The middle class (defined as those between the 40th and the 60th percentiles of income) isn't falling behind or "disappearing." It is getting richer. The lower income bound for the middle class has risen by about $12,000 (after inflation) since 1967. The upper income bound for the middle class is now roughly $68,000—some $23,000 higher than in 1967. Thus, a family in the 60th percentile has 50 percent more buying power than 30 years ago. To paraphrase John F. Kennedy, this has been a "rising tide" expansion, with most (though not all) boats lifted.

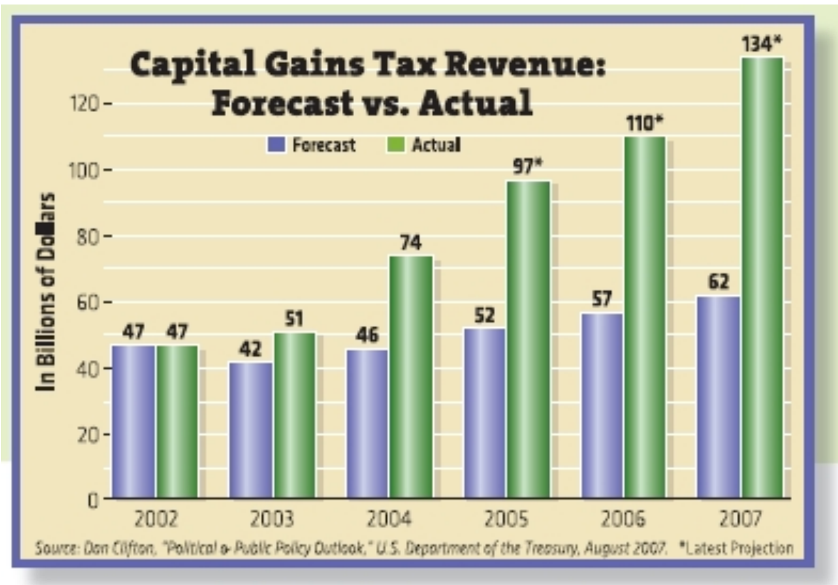
10. Does the tax distribution look a lot different if we factor in other federal taxes, such as the payroll tax?

It's true that the distribution of taxes is somewhat more equally divided when payroll taxes are accounted for—but the change is surprisingly small. Payroll taxes of 15 percent are charged on the first dollar of income earned by a worker, and most of the tax is capped at an income of just below $100,000. The Tax Policy Center, run by the Urban Institute and the Brookings Institution, recently studied payroll and income taxes paid by each income group. The richest 1 percent pay

27.5 percent of the combined burden, the top 20 percent pay 72 percent, and the bottom 20 percent pay just 0.4 percent. One reason that the disparity in tax shares is so large is that Americans in the bottom quintile who have jobs get reimbursed for some or all of their 15 percent payroll tax through the earned-income tax credit (EITC), a fairly efficient poverty-abatement program.

11. How do tax rates in the United States compare with tax rates abroad?

Overall, taxes are between 10 percent and 20 percent lower in the United States than they are in most other industrial nations. This gives America a competitive edge in world markets. But America's lead in low tax rates is shrinking. For example, the United States now has the second-highest corporate income tax in the developed world, after Japan. Our personal income tax rate is still low by historical standards. But in recent years many European and Pacific Rim nations have been slashing income taxes—there are now ten Eastern European nations with flat-tax rates between 12 percent and 25 percent—while the political pressure in Washington, D.C., is to raise them.



12. Do tax cuts on investment income, such as George W. Bush's reductions in tax rates on capital gains and dividends, primarily benefit wealthy stockowners?

The New York Times reported that America's millionaires raked in 43 percent of the investment tax cut benefits in 2003. It's true that lower tax rates have been a huge boon to shareholders—but most of them are not rich. The latest polls show that 52 percent of Americans own stock and thus benefit directly from lower capital gains and dividend taxes. Reduced tax rates on dividends also triggered a huge jump in the number of companies paying out dividends. As the National Bureau of Economic Research put it, "The surge in regular dividend payments after the 2003 reform is unprecedented in recent years." Dividend income is up nearly 50 percent since the 2003 tax cut.

The same phenomenon occurred with the capital gains tax, which is essentially a voluntary tax because asset owners can avoid it by simply holding onto their stock, home, or business. This "lock-in" effect, as it is called, can be economically inefficient, since owners have a tax incentive to keep poor investments, rather than drawing out the cash and putting it into assets that are more productive. When the capital gains tax is cut, people unlock their assets and reinvest in other enterprises.

The 1997 tax reform, passed under President Clinton, reduced the capital gains tax rate from 28 percent to 20 percent, and taxable capital gains nearly doubled over the next three years. The 2003 reform brought the rate down to 15 percent, and between 2002 and 2005 there was a 154 percent increase in capital gains reported as income.

This explosion in realized gains cannot be explained only by the rise in the stock market, which averaged just 13 percent annually between 2003 and 2005. Capital gains tax receipts also far outpaced the revenues that the government's static models predicted. Between 2003 and 2007, actual tax receipts exceeded expectations by $207 billion.