

TAX FEATURES[®]

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Top Income Earners Continue to Shoulder Greater Share of Income Taxes

According to preliminary data released by the Internal Revenue Service, the top 1 percent of U.S. income earners (those who earn over \$185,791 in gross income) paid over 28 percent of federal individual income

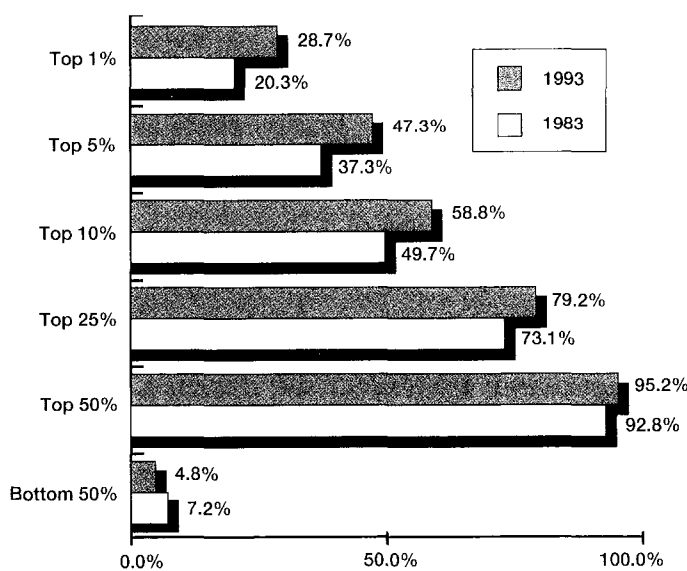
taxes in 1993, the latest year that such data is available. (See Chart 1.) That compares with a share of about 20 percent in 1983.

The same data shows that the top 5 percent of income earners (earning over \$87,154) paid almost half the federal individual income taxes — 47.3 percent — in 1993. This compares with a share of 37.3 percent a decade before. Meanwhile, the top 50 percent of income earners now pay about 95 percent of these taxes, up from 93 percent in 1983.

“Americans at the upper end of the income scale are continuing to see their portion of the total federal individual income tax burden steadily increase,” observed Tax Foundation Economist Patrick Fleenor, who produced the Foundation analysis.

Chart 2 contrasts income shares (that is, adjusted gross income) and tax shares for different income groups. While high-income earners claim a large share of the nation’s total income, they pay an even greater share of the total federal individual income tax burden. For example, the top 5 percent of earners claimed almost 28 percent of total income in 1993, while paying 47 percent of federal individual income taxes. The top 10 percent of earners earned 39 percent of all income but paid about 59 percent of these income taxes. The bottom 50 percent (those

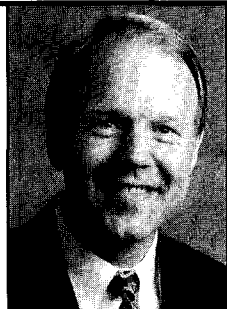
Chart 1: Percent of Federal Individual Income Taxes Paid by Income Group



Source: Preliminary IRS data.

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Reforming the Earned Income Tax Credit

Senator Don Nickles (R-Oklahoma)

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U.S. Congress Confronts Ugly Debt Picture

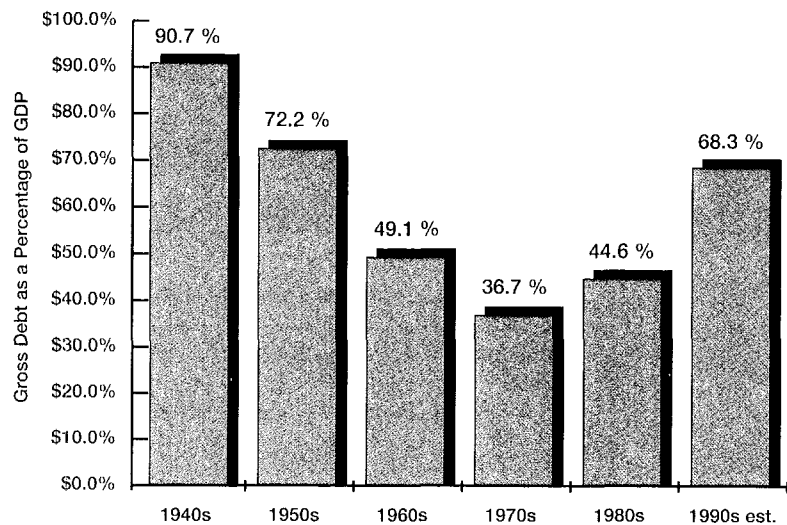
Federal gross debt this decade has reached its highest level as a percentage of gross domestic product since the 1950s, when the federal government was still saddled with much of the debt it incurred during World War II. As Congress prepares to consider raising the national debt ceiling, a Foundation analysis by Economist Patrick Fleenor shows that the federal gross debt hovers around 68.1 percent of GDP thus far in the 1990s, an amount unprecedented during peacetime (see Chart 1).

If every resident of the United States were invoiced for his or her share of this year's gross federal debt, the bill would come to \$18,654 (see Chart 3 on page 3). That compares, in constant 1995 dollars, to a per capita bill of \$14,780 in 1990. In fact, since 1980 the average American's portion of the debt has more than doubled in real terms — from \$7,382 to its current level. The per capita debt is expected to rise to \$20,175 by the year 2000.

The federal debt, and more specifically the annual interest payments on the debt, pose major problems for congressional budgeters. This year, net interest payments are expected to total \$234 billion — roughly 15 percent of total federal outlays. Yet, there has in fact never been a time when the nation did not have federal debt. The closest the U.S. has ever come to wiping out its federal debt was in 1836, when the public debt was listed at \$38,000.

Chart 2 on page 3 shows the gross federal debt each fiscal year since 1960, both in current and constant dollars. Between fiscal years 1960 and 1975, the debt grew roughly 2 percent in real terms. From that point forward the debt skyrocketed. Between FY 1981 and FY 1990 it increased 122 percent in real terms, and though the rapid growth has slowed some, the debt is expected to grow another 40 percent between FY 1991 and FY 2000. Chart 4 on page 3 breaks this growth down into five-year periods, in current dollars. •

Chart 1: Federal Gross Debt as a % of GDP, Averages by Decade



Source: Tax Foundation calculations based on Office of Management and Budget data (Mid-Session Review, July 1995).

Tax Foundation Gives Congressional Staff a Taste of Business — and Business Taxes



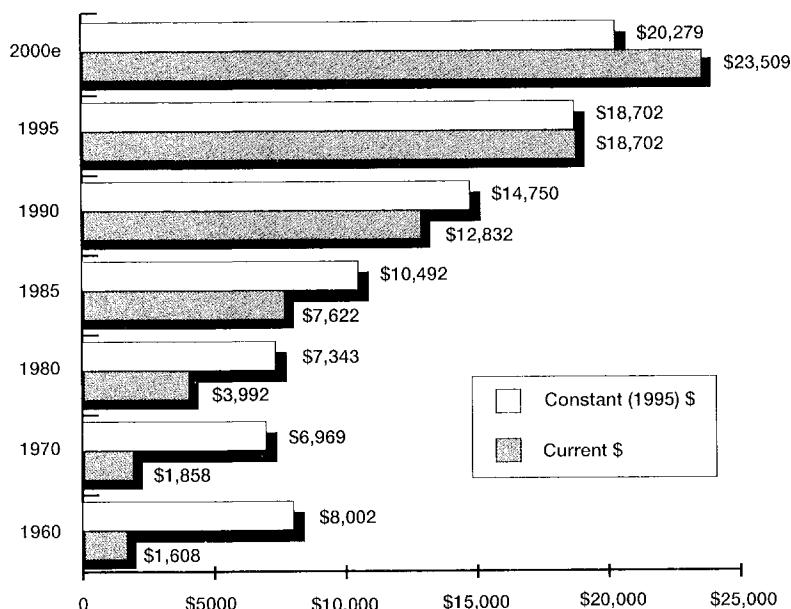
Robert Mottice of the Joint Economic Committee (left) and Trevor Norris of the Postal Rate Commission (center) team up in a recent Profit Ability seminar, as Bob Kastner of Cornell University looks on. The three-day business simulation, co-sponsored by the Tax Foundation and George Mason University's Center for Market Processes, brought together over a dozen congressional staff and other policymakers to give them an appreciation for the financial operations of for-profit companies.

Chart 2: Gross Federal Debt, FY 1960–2000
(\$Billions)

	Gross Federal Debt	
	Current \$	Constant (1995) \$
1960	\$290.5	\$1,445.8
1961	292.6	1,443.1
1962	302.9	1,467.6
1963	310.3	1,477.5
1964	316.1	1,483.1
1965	322.3	1,479.8
1966	328.5	1,464.2
1967	340.4	1,467.1
1968	368.7	1,531.4
1969	365.8	1,446.6
1970	380.9	1,429.0
1971	408.2	1,455.6
1972	435.9	1,477.5
1973	466.3	1,505.7
1974	483.9	1,451.7
1975	541.9	1,478.8
1976	629.0	1,593.8
1977	706.4	1,656.2
1978	776.6	1,692.7
1979	829.5	1,663.6
1980	909.1	1,672.3
1981	994.8	1,661.1
1982	1,137.3	1,767.5
1983	1,371.7	2,046.7
1984	1,564.7	2,236.2
1985	1,817.5	2,502.0
1986	2,120.6	2,835.1
1987	2,346.1	3,046.2
1988	2,601.3	3,259.2
1989	2,868.0	3,438.5
1990	3,206.6	3,686.1
1991	3,598.5	3,971.7
1992	4,002.1	4,290.3
1993	4,351.4	4,556.4
1994	4,643.7	4,769.0
1995e	4,914.0	4,914.0
1996e	5,228.2	5,075.7
1997e	5,551.7	5,232.9
1998e	5,863.2	5,365.6
1999e	6,167.0	5,479.2
2000e	6,460.7	5,573.1

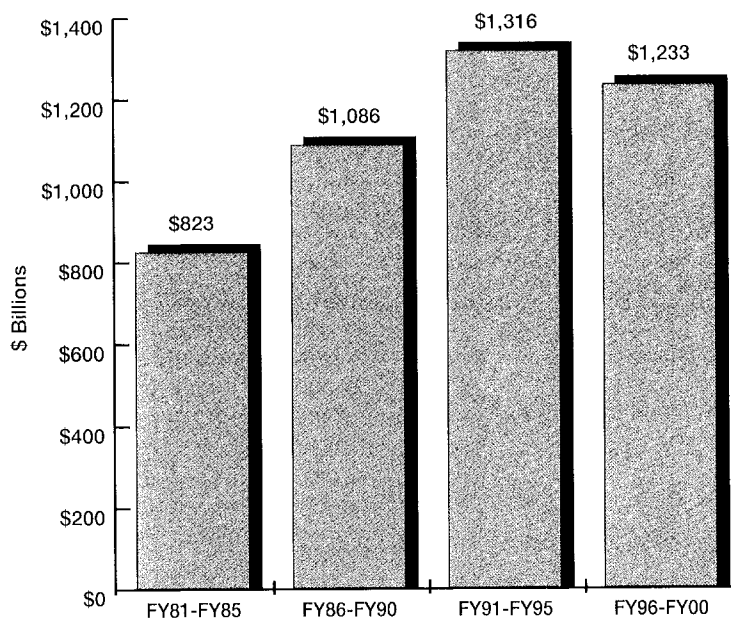
Source: Office of Management and Budget (Mid-Session Review, July 1995).

Chart 3: Per Capita Gross Federal Debt, FY 1960–2000



Source: Tax Foundation calculations based on OMB data.

Chart 4: Gross Federal Debt Growth in Five-Year Periods, FY1981–FY2000



Source: Tax Foundation calculations based on OMB data.

Reforming the Earned Income Tax Credit

By Senator Don Nickles
(R-Oklaboma)

In passing welfare reform legislation, this Congress has taken an historic step toward solving a number of the most serious problems facing this nation, ending the tragic effects of welfare dependency, curbing out of control spending, and moving toward a balanced budget.

But there is much left to be done, including reform of the nation's fastest-growing, most fraud-prone income transfer welfare program, the Earned Income Tax Credit (EITC).

The EITC was enacted in 1975 to offset payroll taxes for low-income

be reformed is its exploding cost. From 1975 to 1986 the EITC cost between \$1 billion and \$2 billion per year. Since then, its cost has skyrocketed to \$7 billion in 1990, \$25 billion this year, and \$36 billion in 2002. EITC growth rates for each of the last five years are 60 percent, 17 percent, 20 percent, 40 percent, and 16 percent, respectively. Amazingly enough, expenditures for the EITC already exceed the federal cost of Aid to Families with Dependent Children.

Proponents of the EITC's original purpose of reducing the tax burden on working families should consider the following facts:

- Approximately 80 percent of the cost of the EITC is direct handout, or federal outlays paid directly to individuals who have zero income tax liability.

- Consider further that, although the EITC is supposed to encourage work, the Government Accounting Office found that the average EITC recipient worked only 1,300 hours a year, compared with a normal work year of 2,000 hours.

- The maximum EITC is equally available to both a frycook who works 2,000 hours per year at \$5 per hour and a part-time lawyer who works 100 hours per year at \$100 per hour.

- Finally, in a dramatic departure from the EITC's original purpose to help families, President Clinton's expansion of the program opened it up to taxpayers without children.

The most unsettling part of the EITC story are the numerous studies by the IRS, the GAO, and others which have revealed massive program losses due to fraud and error. These studies estimate that between 20 percent and 30 percent of all EITC benefits are lost to fraud and error.

Why does the EITC attract such abuse? Because the EITC offers big checks for persons who can manage their income so that it falls within a certain range. The maximum credit for a multiple-child family is \$3,110 in 1995. That is a massive increase

The EITC was enacted in 1975 to offset payroll taxes for low-income families with children and provide an incentive for work. Unfortunately, what began as a small work "bonus" has ballooned into a massive wealth redistribution program.

families with children and provide an incentive for work. Unfortunately, what began as a small work "bonus" has ballooned into a massive wealth redistribution program. Over the past several years the EITC has been the fastest growing and most fraud-prone entitlement program in government.

During his state of the union address in January, President Clinton called the 1993 EITC expansion a "working family tax cut." In my opinion the EITC can hardly be called a tax cut. Over 80 percent of its cost is direct outlays paid in lump sum to individuals with no tax liability. Although beneficiaries have the option of receiving the EITC in monthly installments, almost 99 percent choose to receive it in a lump sum payment. The EITC is essentially a negative income tax with a more attractive but deceptive name.

The primary reason the EITC must



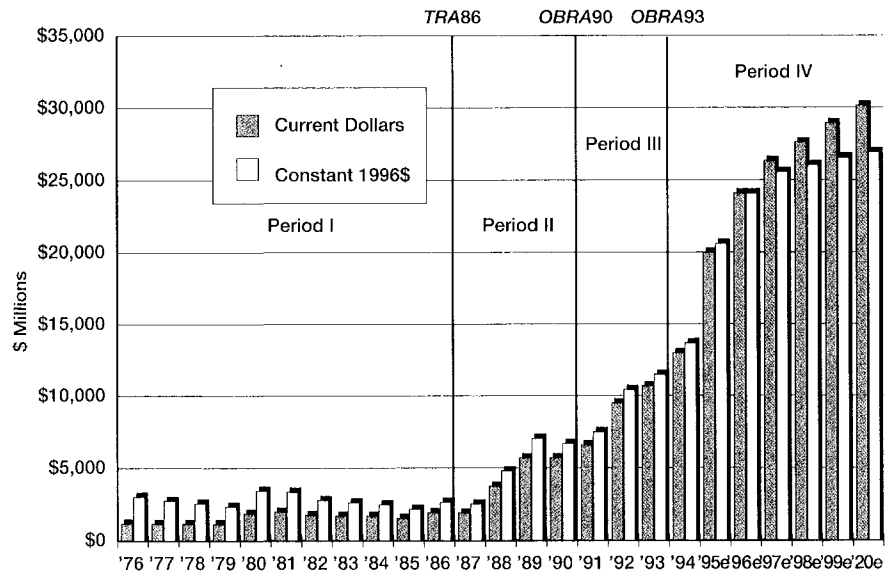
from just five years ago when the maximum credit was \$953. Without reform, this amount would increase to \$4,068 by the year 2000.

To curb this program's exploding cost, we must reduce fraud and error and slow its growth. That is why I joined Senator William Roth (R-Del.) in sponsoring our package of EITC reform proposals. Our bill is crafted so that it does not take away from those for whom the program was originally designed, yet slows the EITC's tremendous growth rate. The bill will also help the IRS stop fraud and prevent those with significant other income and assets from getting the welfare benefits of the EITC.

Specifically, our bill would deny the EITC to illegal aliens, repeal the EITC childless benefit, freeze the EITC credit and income thresholds at 1995 levels, enhance the existing welfare test, and create other income tests. According to preliminary estimates by the Joint Committee on Taxation, our bill will reduce federal expenditures for the EITC by \$39 billion over five years and \$128 billion over 10 years.

The misrepresentations of the critics of EITC reform notwithstanding, these reforms must be enacted if we are ever to reign in the exploding cost of the federal government, most of which can be traced to out-of-control entitlement programs like EITC.

Total Value of the EITC



Source: Tax Foundation; Office of Management and Budget; Joint Committee on Taxation.

Federal Payments, Average Credit, and Eligible Families for the EITC, 1976-2000

	Tax Liability Reduction Portion of the EITC* (\$Millions)	Refundable Portion of the EITC (\$Millions)	Total EITC (\$Millions)	Number of Families Eligible for EITC† (Thousands)	Avg. Credit Per Family
1976	\$368	\$808	\$1,176	6,473	\$182
1977	253	901	1,154	5,627	205
1978	272	881	1,153	5,192	222
1979	364	773	1,137	7,135	159
1980	573	1,275	1,848	6,954	266
1981	654	1,318	1,972	6,717	294
1982	543	1,201	1,744	6,395	273
1983	476	1,213	1,689	7,368	229
1984	489	1,193	1,682	6,376	264
1985	432	1,100	1,532	7,432	206
1986	507	1,415	1,922	7,156	269
1987	482	1,410	1,892	8,738	216
1988	1,039	2,698	3,737	11,148	335
1989	1,691	4,002	5,693	11,696	487
1990	1,334	4,354	5,688	12,612	451
1991	1,705	4,885	6,590	13,105	503
1992	2,144	7,345	9,489	13,433	706
1993	1,901	8,781	10,682	14,004	763
1994	2,050	10,950	13,000	18,059	720
1995 est.	3,143	16,844	19,987	18,411	1,086
1996 est.	3,877	20,216	24,093	18,692	1,289
1997 est.	4,178	22,166	26,344	19,010	1,386
1998 est.	4,379	23,229	27,608	19,163	1,441
1999 est.	4,591	24,357	28,948	19,538	1,482
2000 est.	4,783	25,375	30,158	19,788	1,524

*Tax Foundation estimates based on data from the Office of Management and Budget and Joint Committee on Taxation.

†After 1994, eligible families derived from Tax Foundation estimates using data from Joint Committee on Taxation and Internal Revenue Service.

Source: Tax Foundation; Office of Management and Budget; Joint Committee on Taxation.

Federal Income Tax

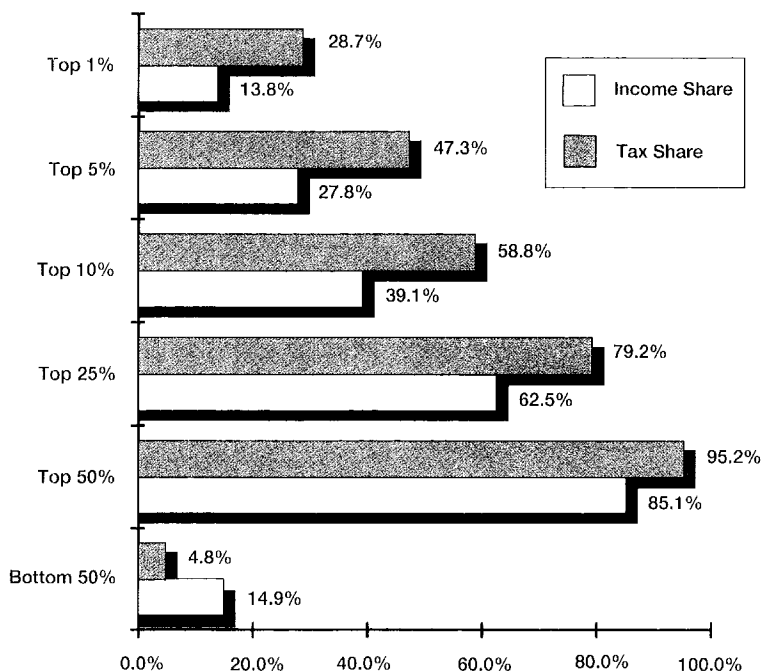
Continued from page 1

making less than \$21,158) earned 15 percent of all income in 1993 but paid only 5 percent of personal income taxes at the federal level.

Chart 3 shows the average tax rates for these income groups, along with the income split points and the total income and personal income taxes paid. The average income tax rate for the top 1 percent of income earners is around 28 percent. From there the average rate declines steadily as the group expands to include lower-income taxpayers. The top 5 percent of earners has an average rate of 23 percent, the top 10 percent an average rate of 20 percent, and the top 50 percent an average rate of 15 percent.

From 1983 to 1993, the AGI for all taxpayers rose 92 percent, while overall federal individual income taxes rose 84 percent. In contrast, federal social insurance payroll taxes rose faster than incomes over the same period, climbing 105 percent between 1983 and 1993. •

Chart 2: Income Share v. Tax Share, 1993



Source: Preliminary IRS data.

Chart 3: Who Pays Federal Individual Income Taxes, 1993

	Number of Returns (000)	AGI* (\$000,000)	Income Taxes Paid (\$000,000)	Group's Share of Total AGI	Group's Share of Total Taxes	Income Split Point	Average Tax Rate
All Taxpayers	113,681	\$3,775,578	\$500,733	100.0%	100.0%	—	13.26%
Top 1%	1,137	520,640	143,939	13.79	28.75	above \$185,791	27.65
Top 5%	5,684	1,048,173	236,976	27.76	47.32	above \$87,154	22.61
Top 10%	11,368	1,474,838	294,386	39.06	58.79	above \$66,196	19.96
Top 25%	28,420	2,357,956	396,596	62.45	79.20	above \$41,192	16.82
Top 50%	56,841	3,212,298	476,601	85.08	95.18	above \$21,158	14.84
Bottom 50%	56,841	563,280	24,132	14.92	4.82	below \$21,158	4.28

* Adjusted Gross Income
Source: Preliminary IRS data.

Conference Plans Timely Focus on Income Tax Reform

"There are crossroads in every major tax reform," observes J.D. Foster, Executive Director and Chief Economist at the Tax Foundation, "points along the debate at which fundamental decisions are made. We stand at one such crossroad, facing a choice as to which approach to use as a base from which to launch tax reform."

With that in mind, the Tax Foundation plans to act as traffic cop in the intersection of the crossroads, exploring the issue of "Tax Reform at a Crossroads" at its November 16 national conference in New York.

The conference will kick off at 12:30 p.m. with a keynote address on "The Decision Matrix for Designing a Restructured Federal Tax System," by Kenneth Kies, Chief of Staff, Joint Committee on Taxation.

The afternoon conference includes three panels (speaker affiliations are in parentheses):

- "Paths of Fundamental Tax Restructuring"—Panelists Andy Laperriere (House Majority Leader's Office), Walt Lukken (Sen. Richard Lugar's office), and Ernest S. Christian (Center For Strategic Tax Reform) will present the case for their respective alternative tax systems.

- "The Effects of the Tax Reform Proposals on Specific Industries"—Peter Merrill, a Partner at Price Waterhouse, explores how the respective options will affect tax burdens in specific industries.

- "The Kemp Commission on Tax Reform"—Alan Reynolds, Research Director at the National Commission on Economic Growth and Tax Reform, provides insights into the Kemp Commission's thinking and the evolution of its views.

As it has for over half a century, the Tax Foundation's national conference will be held at The Waldorf-Astoria in New York City. The event will commence with a lunch and the presentation of the Foundation's third annual Tax Policy Service Award to Robert L. Bartley, Editor of *The Wall Street Journal*. •

FOUNDATION MESSAGE

The first month of the new fiscal year and, once again, the federal government is operating under a temporary budget known as a continuing resolution. That, and the looming titanic battle for budgetary supremacy, are about all this year's fight have in common with past budget calamities.

This year it's the Republicans who are talking about raising taxes on some businesses to pay for tax cuts for others. Even if the proposed tax increases represent good tax policy in and of themselves, this is still a curious turn of events for a group of revolutionary contractors with America.

Even more interesting, some congressional conservatives are now talking about raising income taxes on some individual taxpayers, upper-income taxpayers, no less. How, you ask? By replacing the personal exemption for children with a tax credit for children. How does this raise taxes? Because the exemption is worth more to taxpayers with higher tax rates. If the credit is set so as to leave someone in the 28 percent

bracket with no net change in tax liability, then someone in the 15 percent bracket gets a tax cut and anyone in the 34 or 35 percent brackets will get a tax increase. Again, it makes some sense to replace the exemption with a tax credit since there is really no reason upper-income taxpayers should get more tax relief than lower-income taxpayers just for having a family. But a tax increase now? Curiouser and curiouser.



J.D. Foster
Executive Director and
Chief Economist

Part of the explanation may be that the tax cutters have become trapped by the distribution tables. Again. These aggregate figures disguise the fact that of two individuals at the same tax rate, one can get a tax increase and the other a tax cut and the net effect in the distribution table can be an increase, no change, or a tax cut. Some upper-income taxpayers would no doubt see a reduction in their federal income taxes, like retirees

(who already get some relief under the bill) who have significant amounts of capital gains. But others would see an increase, like taxpayers with primarily labor income. Particularly those with little investment income.

We're all familiar with the term "politically correct". It seems the tax cutters are now caught in the tax policy equivalent thereof, which is an urging to be "distributionally correct". There's no reason when tax increases made in a distributionally correct manner make a muck of the tax code that distributionally correct tax cuts shouldn't do the same.

There are also rumblings about temporary tax cuts, even temporary capital gains reductions. You'd think by now we'd have learned from the experience with the R&E tax credit that the surest way to minimize the effectiveness of a tax incentive is to raise questions about its permanence.

And there is also talk of retroactive tax provisions. It's bad enough the tax bill would cut taxes in meaningless ways from an economic incentive perspective (see, for example, anything sensible written about the family tax credit), but retroactive tax policies? Doesn't anything guide tax policy any more beyond political imperatives.

The other interesting development is how the Administration has interwoven talk about defaulting on the national debt with whether the debt limit is increased and with whether the government has a final budget for the year. Usually, the Treasury is the first to quash any hint that a default is even thinkable. The Administration is now not only talking about the possibility, but using the possibility of a default as a tool in the budget battles.

No doubt we'll see a few more curious turns of events before this budget battle is over, especially with the Presidential campaigns loomer ever larger. Republicans raising taxes? Treasury talking default? Before we're through, we may have a new entry for Ripley's Believe It or Not.

Survey Looks at Why Firms Choose Before-Tax or After-Tax Bonus Plans

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Why do some firms reward managers bonuses based on before-tax income while others use after-tax income?

The question is explored in a new Tax Foundation study authored by Professors Gregory A. Carnes of Northern Illinois University and Darly M. Guffey of East Carolina University. The authors produced the report — titled “The Determinants of the Choice of Income Type as a Measure of Performance in Bonus Plans” — as part of the Tax Foundation/Ernst & Young Visiting Professor program.

The question is important, the authors note, because it can help explain why firms place varying levels of importance on strategic tax planning. The optimal strategy, say Professors Carnes and Guffey, will consider taxes and other business costs simultaneously by focusing on the maximization of after-tax income in the strategic planning process. Managers should be provided with the best incentives to minimize taxes and other business costs simultaneously, since both costs are “so substantial that to ignore either would lead to sub-optimal decisions.”

In their survey, Professors Carnes and Guffey obtained financial information for 266 firms, 80 with after-tax bonus plans and 186 with before-tax bonus plans. Their analysis examined the combined impact of the number of segments, management stock ownership, the degree to which firms are multinational, and firm size on bonus plan type.

As expected, the study shows that firm size plays a large role in determining whether a firm defines income on an after-

tax or before-tax basis for executive compensation. Because there is nothing about firm size that explicitly affects bonus-plan choices, the authors observe that the firm-size variable must be functioning as a proxy for some other effect related to size — “such as the greater ability of larger firms to engage in tax planning.”

In addition, given firms of identical size, the survey indicates that:

- A firm's domestic or multinational status has no marginal impact on the firm's bonus plan.
- However, if one firm has few operating segments and the other has many, then the firm with many segments is more likely to use after-tax plans.
- In addition, as the level of management stock-ownership rises, there is greater likelihood of using after-tax bonus plans. However, this confluence-of-interest may be reduced or eliminated over a certain range of management ownership (in the 5 to 25 percent range).

The authors suggest that systematic differences do exist between firms that reward strategic tax planning and those that do not. “An understanding of the reasons for these differences,” say Professors Carnes and Guffey, “should help provide a better understanding of the decision-making processes of firms with regard to strategic tax planning.” For example, while it appears that it is productive for firms with more business segments to encourage strategic planning, it is not clear that it is desirable for the level of management stock-ownership to influence the manner in which executives are compensated. •

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