TAX FOUNDATION

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Latest Data Shows Trend Reversal: Top 1% Not Paying Larger Share of Federal Income Taxes

According to preliminary data released by the Internal Revenue Service, the top 1 percent of U.S. income earners bore a slightly smaller portion of the total federal individual income tax burden in 1994 (28.67 percent) than it did in 1993 (28.75 percent). At the same time, however, that group bore a significantly greater burden in 1994 than in 1984, when the top 1 percent accounted for 21.1 percent of federal individual income taxes paid.

The 1994 data is the latest year for which such data is available.

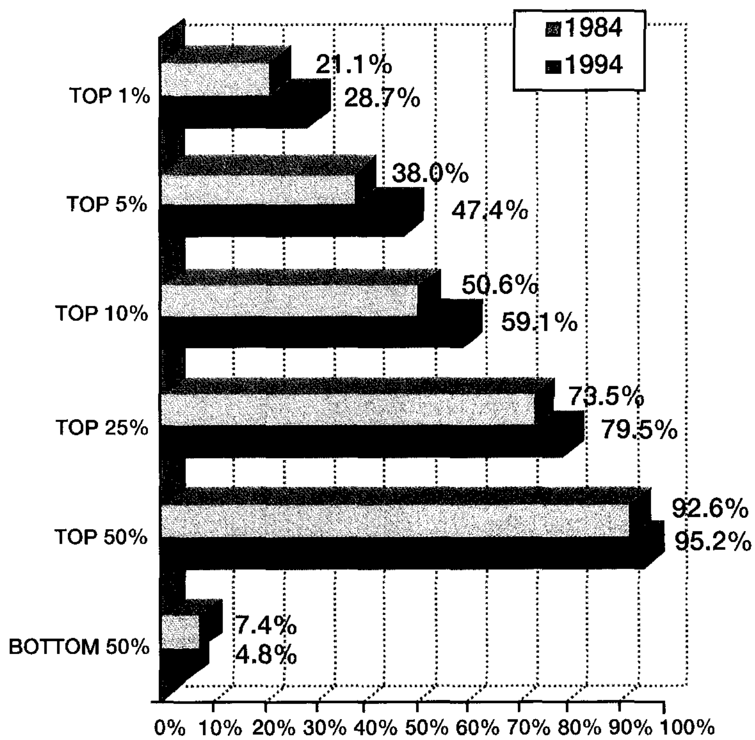
"Overall, Americans at the upper end of the income scale are continuing to bear a historically large share of the total federal individual income tax burden," observed Tax Foundation Economist Patrick Fleenor, who compiled the data.

As Chart 1 illustrates, the top 5 percent of income earners (with annual income over $90,913) and the top 10 percent (with annual income over $68,737) both pay a significantly greater portion of federal individual income taxes than they did a decade ago.

Chart 2 contrasts income shares (that is, adjusted gross income) and tax shares for different income groups, and demonstrates the progressivity of the federal income tax system. 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 10 percent of earners (those making above $68,737)

Who Pays Income Taxes *continued on page 2*

Chart 1: Percent of Federal Individual Income Taxes Paid by Income Group, 1984 & 1994



Source: Tax Foundation calculations based on preliminary IRS data.

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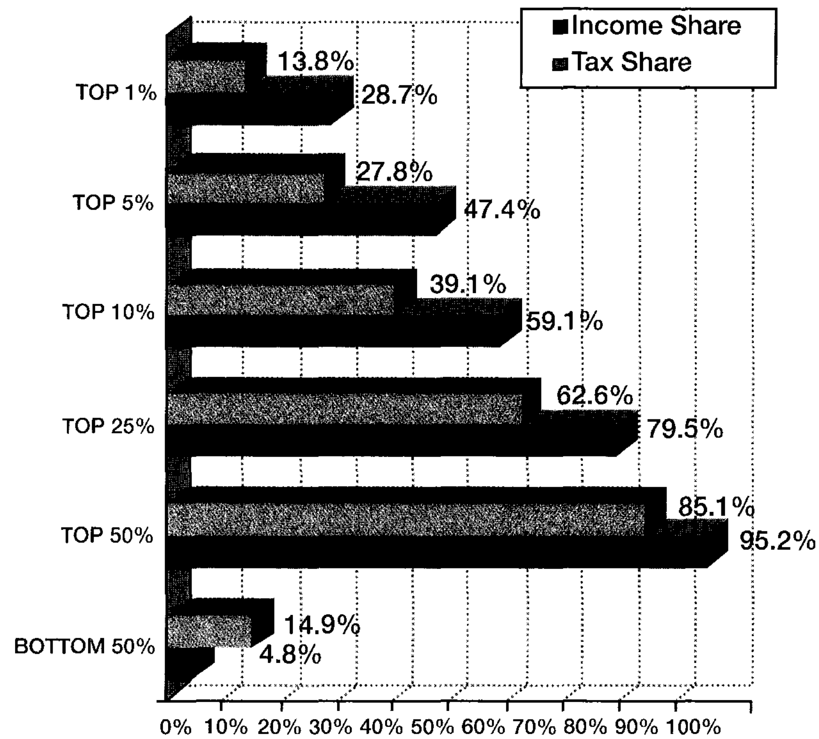
earned 39.2 percent of all income in 1994 but paid 59.1 percent of all federal individual income taxes. The bottom 50 percent (those making less than $21,817) earned 14.9 percent of all income in 1994 but paid only 4.8 percent of federal individual income taxes that year.

Mr. Fleenor notes that in light of the fact that the top-marginal rate fell from 50 percent in 1984 to 39.6 percent in 1994, many observers may find it surprising that top earners are shouldering a larger share of the overall tax burden. But, Mr. Fleenor states, the data tend to support the notion that "lowering high marginal tax rates on upper income earners may increase, not decrease, total tax revenue." As further evidence of this proposition, he points to the drop in the top 1 percent's tax burden from 1993 to 1994. According to Mr. Fleenor, 1994 was the first year that individuals could fully respond to the 1993 retroactive increase in the top marginal individual tax rate from 31 to 39.6 percent. As a result, the share of total taxes paid by the nation's top earners fell slightly — a result that was the exact opposite of that predicted by proponents of the rate hike.

Chart 2: Income and Federal Individual Income Tax Shares of Income Groups, 1994



Source: Tax Foundation calculations based on preliminary IRS data.

Chart 3: Who Pays Federal Individual Income Taxes, 1994

	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	114,990	$3,961,146	$532,643	100.0%	100.0%	–	13.4%
Top 1%	1,150	546,720	152,696	13.8	28.7	above $195,981	27.9
Top 5%	5,749	1,102,836	252,385	27.8	47.4	above $90,913	22.9
Top 10%	11,499	1,552,121	314,786	39.2	59.1	above $68,737	20.3
Top 25%	28,747	2,481,040	423,328	62.6	79.5	above $42,734	17.1
Top 50%	57,495	3,371,349	507,120	85.1	95.2	above $21,817	15.0
Bottom 50%	57,495	589,797	25,523	14.9	4.8	below $21,817	4.3

Source: Tax Foundation calculations based on preliminary IRS data.

Tax Foundation Survey: "What is Income?"

In conjunction with a forthcoming Tax Foundation *Background Paper* on the economic definition of income, the Foundation wants to discover the "popular" definition of income with the following survey. Please complete the survey by circling the response to each question that corresponds to your understanding of the term "income." Completed surveys can be faxed to the Foundation at 202-942-7675 or mailed to Tax Foundation Survey, 1250 H Street, NW, Suite 750, Washington, D.C. 20005-3908.

1. Please mark the answer that best describes you career experience:

A. Accounting
B. Finance
C. Lawyer
E. Legislator/Policy Maker
F. Student
G. Other

2. Suppose a certain stock earns $3 a share during a certain year, but the company pays out in dividends $2 per share, the other $1 being undivided profits on the books of the company. You own 1,000 shares, so that you receive in that year $2,000 in dividends. What would you ordinarily consider your income from that stock?

A. $2,000
B. $3,000
C. $0
D. Undecided

3. Suppose your wages to be $40,000, and, out of this, you save $10,000 (by depositing it in a savings bank, buying a bond, putting it into your business, or otherwise). Would you think of your total income as

A. $30,000
B. $40,000
C. Undecided

4. Suppose you have stock worth $100,000 on the market January 1, 1996. On December 31, 1995 (12 months later), this stock has increased in value to $107,000. No dividends are paid by the company for that year, and you neither buy nor sell any of the stock during 1995. Do you regard this $7,000 increase in stock value as income?

A. No
B. Yes
C. Undecided

5. Suppose you have $1,000 in a savings bank. The bank allows 5% interest on this and so increases your account by $50 during a period of one year. Would you consider this $50 as part of your income?

A. No
B. Yes
C. Undecided

6. You have $1,500 in a savings bank. The bank allows you 5% interest and so increases your account by $75 during a period of one year. On December 31 you withdraw $60 of this accrued interest to pay bills. What would be your income from this savings account?

A. $60
B. $75
C. Undecided

7. On January 1, 1995, you have a savings account of $500. The bank paid 5% interest. On December 31, 1995, 12 months later, your accrued interest amounted to $25, and you withdrew it. Later, during the same day, you changed your mind and deposited the same $25 in the same account. What was your income from that account for the year?

A. $0.00
B. $25.00
C. Undecided

8. For many years your income has been $50,000 a year. Last year in your spare time you diligently worked a small mining claim, which suddenly brought you an additional $500,000. Of this $500,000, you spent $50,000 on a new boat and invested $450,000 in bonds. What was your income for that year?

A. $100,000
B. $550,000
C. Undecided

9. Suppose your investments were worth $100,000. This year you received and spent $5,000 from those investments, but your investments shrank in value to $99,000. Which of the following items would be your "income" for this year?

A. $5,000
B. $4,000
C. Undecided

10. On January 1, 1995, you own 2,000 shares of stock worth $20,000. On December 31, 1995, these shares are worth $30,000 and you sell 1000 shares, reinvesting the $15,000 proceeds in other shares. You earn $50,000 in salary over the year, all of which is spent on living expenses. What is your income for the year?

A. $50,000
B. $55,000
C. $60,000
D. Undecided

11. In the example above (Question No. 10), suppose you reinvested $10,000 from the proceeds of the sale of stock, using the other $5,000 to buy a computer. What is your income for the year?

A. $50,000
B. $55,000
C. $60,000
D. Undecided

12. You own shares of stock that pay a dividend of $5,000 over the course of the year. Upon receipt of the dividend you reinvest it in shares of another company. Your salary for the year is $50,000, all of which is used for living expenses. What is your income for the year?

A. $50,000
B. $55,000
C. Undecided

13. You own a strip mall worth $800,000. From January 1, 1995, to December 31, 1995, this mall paid you $40,000, which you used for living expenses. During this period of 12 months the mall was damaged by fire to the extent of $200,000. Which of the following figures represents your income for that period of time?

A. $40,000
B. $-160,000
C. Undecided

14. You have purchased from an insurance company a $6,000 a year life annuity, and on the basis of your age it costs you $50,000. The same policy, if taken out one year later, would have cost you only $49,000. During the year you spent the whole $6,000 to pay bills. Your annuity meanwhile decreased in value (as was stated) by $1,000. What do you consider as your income for that year?

A. $6,000
B. $5,000
C. Undecided

15. Several years ago you purchased an orange grove. The trees were very young and had not yet reached their period of peak production; lack of sufficient water had also prevented the trees from attaining their best growth and productivity. But during the 12-month period of time, January 1, 1995, to December 31, 1995, there was more than sufficient rainfall, and your trees reached a high level of productivity. Real estate experts informed you that your orange grove had increased in value during this 12-month period, and that, whereas it had been worth only $130,000 on January 1, 1995, it was now worth $170,000 on December 31, 1995. This represented an increase of $40,000. During this period of 12 months your salary was $50,000, all of which you used for living expenses. Which of the following figures do you regard as your income for the specified 12-month period?

A. $50,000
B. $90,000
C. Undecided

16. You own a vacant lot which is tax free. On January 1, 1996, the lot was evaluated by a real estate expert at $20,000. On December 31, 1996, 12 months later, the same real estate expert informed you that your lot was now worth $30,000. He also stated that the reason for the $10,000 increase in value was due to the fact that a big corporation was going to build a large factory in the vicinity. During this 12-month period your income from all other sources amounted to $50,000, all of which you used for living expenses. Which of the following figures represented your income for the 12-month period.

A. $50,000
B. $60,000
C. Undecided

Cutting Taxes and Balancing the Budget: The Possible Dream

By Senator Spencer Abraham (R-Mich.)

As the presidential campaign heats up, it is clear that a central issue will be economic growth. Despite recent positive economic news, the long-term outlook is not good. Growth is slow and family incomes are down. At the same time, the tax burden on Americans is at an all-time high, squeezing families while discouraging saving and investment.

In response to this disturbing trend, Bob Dole has proposed an aggressive plan to both cut taxes and balance the budget by the year 2002. The goal of the plan is to spur economic growth by reducing both the size and tax burden of the federal government. Its centerpiece is a 15 percent, across-the-board income-tax cut designed to lower taxes on families and small businesses while spurring job creation and investment. The Dole plan would also provide families with a $500 per child tax credit, improved IRAs, and lower taxes on capital gains. For a typical family of four, his plan would allow them to keep an additional $1600 per year, enough to pay tuition to a private school, move into a better neighborhood, or save for an early retirement.

> ***Bob Dole has proposed an aggressive plan to both cut taxes and balance the budget by the year 2002. The goal of the plan is to spur economic growth by reducing both the size and tax burden of the federal government.***

People like the idea of a tax cut, and President Clinton knows it. That is why he has offered alternative tax proposals. But don't be confused — Bill Clinton has not offered us a tax cut. In order to balance his budget in 2002, Clinton's proposed tax cuts are temporary, while his proposed tax increases on individuals and businesses are permanent. Terminating the tax cuts results in a net tax increase of about $64 billion through the year 2005. True to form, Bill Clinton is selling one thing, while he intends to deliver something entirely different.

Even before he terminates them, Clinton's proposed tax cuts are hardly anything to write home about. The Clinton plan would reduce taxes by about $16 billion over the next five years, or $3 billion a year. That works out to about 3 cents a day per American, or enough for each of us to buy one stick of gum every 24 hours. Setting aside their minuscule size, the President's tax cuts still offer Americans less rather than more. Unlike the Dole plan, most of Bill Clinton's tax cuts are limited to those Americans who behave the way Washington elites favor. For example, his homeowner and education tax proposals only benefit those Americans who spend their money on Bill Clinton's priorities. If you have other priorities, you get nothing.

President Clinton's tax cuts are restricted in other ways. The Clinton child tax credit, for example, only applies to families with children under the age of 13. In comparison, the Dole proposal would provide $500 per child for children up to 18 years old. That means over 20 million families with teenage children fail to benefit from the Clinton plan. Under the Dole plan, these families will benefit at a critical time when they are saving for the many expenses of launching their children into the adult world.

Bob Dole not only offers Americans more tax relief — $1,600 for the typical American family — he offers them the flexibility to set their own priorities. But Americans wonder how these tax cuts can be achieved without increasing the federal budget deficit or gutting essential federal programs. The answer is, we can balance the budget and provide Americans with tax relief by slowing the growth of government spending. Federal spending over the next six years will total $10.8 trillion. Under the Dole plan, the government would instead spend $10.2 trillion. Spending at this level would permit annual federal spending to continue to grow — not decrease — by two percent a year.

All the same, savings would have to be made. Where would they come from? To begin, the Dole plan builds

Increased economic growth resulting from the Dole marginal tax cuts would add about $147 billion to government revenues, which is sufficient to drive the federal deficit down to zero in the year 2002.

on the comprehensive balanced budget resolution that Congress adopted in June. That resolution calls for $393 billion in budget savings over the next six years. On top of the balanced budget resolution, the Dole plan would reduce projected spending growth by an additional $183 billion over six years, targeting wasteful programs like the Departments of Commerce and Energy and reducing government overhead. Contrary to those groups that have portrayed this proposal as unreasonable, $183 billion in savings represents only five percent of total federal spending — excluding Social Security, Medicare, and defense — over the next six years.

Just that modest restraint in federal spending is more than enough to pay for $548 billion of tax cuts. Then, increased economic growth resulting from the marginal tax cuts would add about $147 billion to government revenues, which is sufficient to drive the federal deficit down to zero in the year 2002.

And all this can be accomplished while protecting universally supported programs such as Social Security and Medicare from spending reductions. Even while cutting taxes and balancing the budget, the Dole plan would allow Social Security spending to increase by 34 percent, while spending on Medicare will rise by 39 percent.

There is nothing extreme or unreasonable about growing the federal government at a slower rate. But many people remain skeptical that President Dole will be able to follow through on Candidate Dole's promises. There are two reasons why they should have more faith. First, Bob Dole has a long history of supporting tax cuts while fighting to balance the federal budget. He supported the Tax Reform Act of 1986, he supported Ronald Reagan's tax cuts in 1981, and he even supported the original Kemp-Roth tax cuts of 1978. Second, as the Senate leader, Bob Dole has already ushered a plan through Congress which would have provided substantial tax relief to American families while balancing the budget in 2002. That plan, the Balanced Budget Act of 1995, was the first proposed budget in 25 years to be in balance, and it was vetoed by President Clinton.

The failure of the Clinton administration to offer Americans meaningful tax relief says much about the transformation of the Clinton presidency. Clinton won the office promising a sizable middle-class tax cut. As president, he enacted the largest tax increase in American history. And now he is running for reelection on a platform comprised entirely of small, narrowly defined, special interest tax benefits.

Under a Dole presidency, however, by limiting the future growth of federal spending to two percent a year, we can reduce income tax rates by 15 percent of every taxpayer, provide a $500 per child tax credit for middle-class families, and cut the capital gains tax rate in half — all while balancing the budget in 2002. The Dole plan is the "possible" dream that will result in smaller, more efficient government that allows families to keep more of what they earn, so they can spend it on their priorities rather than Washington's.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed in these columns are not necessarily those of the Tax Foundation.*

1996 Tax Foundation
59th National Conference and Annual Dinner

Thurday, November 21, 1996
The Waldorf=Astoria
301 Park Avenue, New York, NY 10022

• Registration/Buffet Lunch	11:45 a.m.	Empire Room
• Conference Keynote Address	12:15 p.m.	Empire Room
U.S. Rep. Nick Smith (R-Michigan)		
• Social Security Survey Review	1:00 p.m.	Empire Room
• Conference Sessions	2-5 p.m.	Empire Room
• Dinner Reception	6 p.m.	Hilton Room
• Annual Dinner	7 p.m.	Empire Room
Tax Policy Service Award—Dr. Norman B. Ture, President, IRET		
Public Sector Distinguished Service Award—U.S. Rep. Philip M. Crane (R-Illinois)		
• Post Dinner Reception	9:30 p.m.	Hilton Room

•Hotel reservations deadline for the block of rooms reserved by the Tax Foundation is November 1, 1996. Call Waldorf reservations direct at 1-800-WALDORF.

•Conference and Dinner reservations must be received by November 15, 1996. (Written cancellation for refunds accepted through this date only.)

•Questions about the Conference and Dinner should be directed to Renée Nowland, Tax Foundation, by phone at (202) 942-7653, or by fax at (202) 942-7675.

Conference Program

12:15 p.m.	Keynote Address	Rep. Nick Smith (R-Michigan)
1:00	Special Session	Brent Bahler: "CSE Survey on Social Security"
1:30	Intermission	
2:00	Session One:	"An Examination of the Need for Reform and the Macro Economic Benefits of Reform" Presenter: Michael Tanner, Director of Health and Welfare Studies, Cato Institute Commentator: Dr. Arthur P. Hall, Senior Economist, Tax Foundation
3:00	Session Two:	"An Overview of the Chilean Reform Experience" Presenter: Dr. Ricardo Zabala, Citibank, N.A., Santiago, Chile Commentator: Dr. John Goodman, President, National Center for Policy Analysis
4:00	Session Three:	"In In-Depth Discussion of the Choice That Must Be Made in Crafting Reform Legislation" Presenter: Stephen Entin, Resident Scholar, Institute for Research on the Economics of Taxation Commentator: Mark Weinberger, Attorney-at-Law, Washington Counsel, P.C.
5:00	Closing Remarks	Dr. J.D. Foster, Executive Director and Chief Economist, Tax Foundation

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Conference fee:
Donor–$100, Non-Donor–$150
Reception/Dinner fee:
$400/Person, $4,000/Table

FOUNDATION MESSAGE

When is a Tax Not a Tax?

J.D. Foster
Executive Director
& Chief Economist

The recently enacted welfare reform bill included a reduction in the refundable portion of the Earned Income Tax Credit (EITC). Consistent with past practice the Tax Foundation treated this as a tax increase; the Congress prefers to call it an "outlay reduction." Which is it?

A more fundamental question is: Just what is a tax? When government lays claim to your money and calls it a tax, it's easy to believe you've been taxed. It doesn't matter whether the basis was your income, your purchases, your property, or on your person. If you have less and the government more, then the money you pay certainly seems like a tax. Other levies, however, aren't so easy to figure.

Amounts withheld for Social Security, for example, are commonly called "payroll taxes." This levy reduces take-home pay and yields revenue to the government, but it also qualifies the worker for benefits. From the perspective of the payer, is this a tax and transfer system as is often claimed, or is it a system of contributions and returns as Social Security defenders suggest?

When government imposes a fee for providing a service and the fee is equal to the service's fair market value, should the fee be considered a tax? For example, when you travel to Yellowstone National Park and pay a visitor's fee, is this a tax? As a fair price for services rendered, some might argue that such a fee is not a tax. But income taxes also help establish the price paid for government. Should income taxes not be considered taxes on this basis?

President Clinton recently proposed a graduated filing fee for firms seeking to merge. Companies would pay a fee to have the Securities and Exchange Commission process the paperwork. But unlike a fee-for-service, the company is filing the paperwork because it is required to do so. If an entry fee for Yellowstone Park is a tax, should fees paid for federal filings be considered taxes?

One test in each of these cases might be whether the activity triggering the tax is voluntary. For example, you don't have to go to Yellowstone Park, so under this test a user fee is not a tax. Then again, the argument can be made that income taxes are voluntary, because you could cut back your hours, earn less income, and pay less income tax. So the voluntary activity test appears to work only in certain cases.

Taxes are generally thought to be devices for extracting financial resources from the private sector. Remember that the EITC, however, which is refundable to some individuals, could be considered a "negative" tax. After all, it is commonly called a "tax credit," even in Joint Tax Committee pamphlets, despite the omission of the word "tax" in its statutory name. Is a "negative" tax still a tax, just with the sign changed? Or must a tax always leave the government with more resources and the payer with less?

If a "negative" tax is still a tax, what about when resources are transferred from government to individuals? Should all welfare payments be deemed a "negative" tax for purposes of categorization? Or, suppose a provision of tax law that yields a net payment to the individual is properly treated as an outlay and not a "negative" tax. Wouldn't it be reasonable to call tax provisions that yield revenue to the government "negative outlays?" We already call tax provisions that reduce income tax liability beyond some hypothetical level a "tax expenditure," so there is precedent.

What this all tells us is that there is a continuum of programs to direct government outlays. Where one draws the line establishing where taxes end and outlays begin is unclear. One way is to disregard the letter of the law and common parlance, and adopt a substance-over-form rule. One could, for example, say that a tax must transfer resources from the taxpayer to the government. An outlay, then, would be any provision of law that transfers resources from the government to any other entity, whether individual, business, or other governmental unit. Under such a criterion, the only issue is the direction of the funds, not the name of the law, nor its federal code section. Again, however, there is the Yellowstone Park case in which you paid a fee to offset the government's costs of maintaining the park. So even this common sense rule may require exceptions.

Short of a simple direction-of-funds rule, the question of where to draw the line yields few sure answers. The choice, however, is important politically. For example, consider the broadest definition of a tax that treats all outlays as "negative" taxes. Under this definition, an expansion of the welfare state through the Food Stamp program, for example, is a tax cut, while a reduction in the program is a tax increase.

Similarly, taking the fee-for-services perspective to its extreme, an income tax hike to close a budget deficit would not be a tax increase, but merely the proper pricing of government services.

Coming back to the EITC, the recent welfare reform bill reduced its refundability. The budget rules require that this change be reported as an outlay reduction, even though it reflects the reduction in a "tax" credit, rather than as a tax increase. The political importance of this difference is clear. In one case the change further reduced welfare expenditures; in the other it increased taxes on low-income workers. One's political orientation may determine the choice.

The Tax Foundation treated the change as a tax increase, because the provision is commonly called a tax credit and because we treated it as such when Congress expanded the EITC in 1993. Consistency and fairness required that we treat the 1996 change in the same manner.

Every attempt to define what we mean by a tax seems to require qualifications. There are occasionally good reasons, like historical precedent and consistency, for drawing an arbitrary line along the continuum of programs and saying everything to the left of the line is a tax and everything to the right is an outlay. Absent such a guide, the most intuitive definition may be best, even accepting the user fee problem: A tax is anything that leaves you with less money and the government with more.

Total Tax Burden Overwhelms Family Food, Clothing, Housing Budgets

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The average American household will spend $19,292 on food, clothing, and household costs in 1996 — compared with $21,365 in federal, state and local taxes. According to a Tax Foundation analysis, only those households falling below $22,500 in annual adjusted gross income (AGI) will pay more for food, clothing and household than for taxes.

The total tax burden calculated by the Tax Foundation incorporates all taxes at all levels of government, from federal income taxes and payroll taxes to local property taxes. The average expenditures on food, clothing, and housing were compiled from recent Commerce Department personal consumption tables.

The figures for food, clothing, and housing are stripped of the taxes that generally accompany them in purchases. This is particularly relevant to the housing numbers, where property taxes can add a significant burden to rent and mortgage payments.

Average Household Food, Clothing and Housing Expenses Compared to Average Household Tax Burden, By Income Group, 1996

AGI	Est. 1996 Households (Millions)	Household Food	Household Clothing	Household Housing	Household Food Clothing Housing	Household Total Tax Burden
$15,000 under $22,500	13.68	$4,803	$1,822	$8,000	$14,625	$7,605
$22,500 under $30,000	11.69	4,333	2,031	2,709	9,073	11,311
$30,000 under $35,000	9.22	4,265	1,933	7,421	13,620	15,295
$35,000 under $45,000	7.47	4,644	2,057	8,152	14,852	19,513
$45,000 under $60,000	11.88	5,002	2,268	8,774	16,043	25,276
$60,000 under $75,000	8.21	4,486	2,182	7,237	13,905	33,334
$75,000 under $115,000	8.85	4,752	2,392	7,715	14,858	46,634
$115,000 under $150,000	2.50	5,164	2,706	8,448	16,318	69,127
$150,000 under $300,000	1.77	5,796	3,190	9,570	18,556	110,733
$300,000 under $750,000	0.55	7,343	4,429	12,336	24,108	267,740
$750,000 or more	0.18	11,869	8,530	20,607	41,007	1,289,064
Average Household	109.03	$6,363	$2,669	$10,260	$19,292	$21,365

Note: Households with incomes under $15,000 , not listed above, are a statistical anomaly. Not only do they spend an inordinate portion of their household income on food and housing, much of the income spent on these items are direct transfer payments. However, their numbers are included in the total "Average Household" category.
Source: Tax Foundation estimates based on Census Bureau and Commerce Department data.

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