Putting a Face on America’s Tax Returns:

A CHART BOOK

Second Edition
Tax reform is in the air in Washington these days. It may take time to come to fruition, but there is growing bipartisan agreement that the tax code is too complicated, burdensome, and uncompetitive, and is undermining our economic potential.

The goal of tax reform is not just to design a simpler tax code but a code that promotes economic growth and ultimately raises the standard of living for every American. However, for many in Washington, tax reform is a mechanical process, not an aspirational one. To the lawyers on the tax writing committees, tax reform is about rearranging subsections of the Internal Revenue Code. To the scorekeepers at Congress’s Joint Committee on Taxation, it’s about seeing if the numbers add up. To Members of Congress, it’s about balancing the needs of some interest groups over others. Instead, it should be about helping the American people grow the economy.

What is missing from the process is a real sense of who the people behind the tax returns really are. We’ve compiled this chart book to not only “put a face on American taxpayers,” but to provide some must-know background information on the key issues of the tax reform debate.

For example, before we reform the income tax code, we need to know who pays income taxes and who doesn’t. We also need to be aware of the demographic changes happening in America—such as the aging population—because today’s taxpayers are likely very different from yesterday’s taxpayers.

Before we simplify the tax code, we need to know who benefits from the current tangle of credits and deductions. We then need to understand the economic effects of eliminating these so-called tax expenditures and whether we would be better off trading them for lower tax rates.

If inequality and progressivity are a concern, we need to know how progressive the current tax system is and how it works with spending to redistribute income from some Americans to others.
Corporate tax reform is a must because America now has the highest corporate income tax rate in the industrialized world and it deters investment. But before we reform the corporate tax code, we need to understand that America is an entrepreneurial economy. We have more than 30 million businesses paying taxes under the individual tax system compared to 1.7 million paying taxes under the traditional corporate tax code.

Ideally, a tax code should do only one thing: raise sufficient revenues to fund the size of government people want in the least economically harmful manner possible. Our system is far from that ideal and may never be perfect. Perhaps, if lawmakers and citizens are armed with the facts, we can have an honest debate and move toward a tax code that leads us to a more prosperous America.
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The income tax system in the United States is a sprawling mass of provisions spread across dozens of volumes and has been called everything from a “disaster” to an “abomination.” It takes Americans as many as seven billion work hours every year just to complete the paperwork required. The IRS’s own National Taxpayer Advocate estimates that it costs individual and corporate taxpayers more than $165 billion annually to comply with the income tax code.

These facts alone would be enough to suggest a need for reform, but the compliance burden is only one part of the problem. In order to figure out what we need to fix, we need to understand how the system works now.

This means knowing the kinds of credits and deductions offered to taxpayers and the conditions that affect both how much we pay and the value of government services we receive back. When we take a step back and look at how the system is put together, many of the problems become clearer and, hopefully, easier to solve.

We see, for example, that contrary to some claims that high-income households are not paying their fair share of income taxes, the average tax rate for the top 1 percent of earners is actually twice what it is for the rest of Americans. From there, rates go down significantly, even after all credits and deductions are accounted for, actually becoming negative for individuals earning less than $30,000.

None of these facts on their own tell us which reform options to pursue. But taken together, they present a much clearer picture of the nation’s steeply progressive and highly redistributive federal tax code. In an environment in which potential tax changes are often evaluated based on how they will affect low-income households, it is essential to keep that picture in mind.
In 1913, the federal income tax started as four pages of forms and instructions. Today, the income tax code spans more than 70,000 pages and influences virtually every decision we make. Over the decades, lawmakers have increasingly asked the tax code to direct all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, purchase health insurance, buy a home, replace that home’s windows, adopt children, put them in daycare, purchase school supplies, go to college, invest in historic buildings, spend more on research, and the list goes on.

The growth in social and economic policy driven through the tax code has made the IRS a super-agency, duplicating the work of every other cabinet agency, from Energy and Education to HHS and HUD. Were we to start from scratch, we would not want a tax collection agency to perform these functions.
In 1940, the year before America entered World War II, excise taxes—such as gas and cigarette taxes—were the largest source of revenues for the federal government, followed by Social Security payroll taxes, then corporate income taxes. Today, payroll taxes are still the second-largest share of tax revenues while excise taxes would hardly fund two weeks’ worth of federal spending. Collections from individual income taxes are now the number one source of revenues for Uncle Sam. Corporate income taxes have declined as a source of revenues since the 1950s for many reasons—including the fact that more business income is now taxed on individual tax returns than on corporate returns.
When politicians talk about overhauling the nation’s tax code, they are typically only talking about reforming the corporate and individual income tax systems. Combined, these two sources comprise about 58 percent of all federal revenue in any given year. But it should be noted that the category of “individual income taxes” is comprised not only of collections from wages and salaries, but also includes revenues collected from taxes on other sources such as savings, capital gains, dividends, rents, and business income (including sole proprietors, S corporations, LLCs, and partnerships).

Social insurance taxes are dedicated to funding Social Security and Medicare programs and are generally considered outside the scope of most tax reform proposals.
To understand the distribution of the income tax burden, we must first understand the distribution of tax filers. The median taxpayer earns roughly $33,000. This means that half of the 145 million tax filers (about 72 million or so) earn less than $33,000 and half earn more. While only about 14 percent of taxpayers earn more than $100,000, they pay the vast majority of all income taxes in America today.

We should always keep in mind that no two tax returns are alike. While one tax return may represent the wage income of a single individual or head of household, another may represent the income of a two-earner married couple, composed of a mix of sources such as capital gains, dividends, or even the profits from a family-owned business. Failing to account for these differences can give a false impression of inequality in America.
About half of the nation’s income is reported by taxpayers who make less than $100,000, and half is reported by taxpayers who make more. However, taxpayers who make less than $100,000 collectively pay just 18 percent of all income taxes while those who make more pay over 80 percent of all income taxes. The share of income taxes paid by upper-income Americans, those who earn $200,000 or more, is twice their share of the nation’s income and accounts for more than half of all income taxes paid in 2011. Those making less than $30,000 receive more back from the IRS than they pay in income taxes due to such preferences as the Earned Income Tax Credit and the Child Credit.
The top 1 percent of taxpayers pay a greater share of the income tax burden than the bottom 90 percent combined, which totals more than 120 million taxpayers. In 2010, the top 1 percent of taxpayers—which totals roughly 1.4 million taxpayers—paid about 37 percent of all income taxes. This is a big jump from 1985, when the top 1 percent paid a quarter of all income taxes. Indeed, the income tax burden on the bottom 90 percent has dropped by one-third since 1985.

The top 10 percent of taxpayers now pay more than 70 percent of all income taxes compared to about 55 percent of all income taxes in 1985. Meanwhile, the share paid by the bottom 50 percent of taxpayers (about 67 million in total) has declined over the past 25 years, from 6.5 percent in 1985 to just 2.4 percent today.
People mistakenly believe that because the rich benefit from many popular tax deductions and credits, they pay a lower average (or “effective”) tax rate than other taxpayers. This is not the case. The average tax rate for all Americans is about 10.4 percent. However, taxpayers earning over $1 million pay a 23 percent effective rate and taxpayers earning over $250,000 pay a 21 percent effective rate—more than twice the national average. Meanwhile, “middle class” taxpayers earning between $50,000 and $100,000 pay an effective rate below the national average—just 9 percent. The effective tax rate for Americans making less than $30,000—who owe no income taxes—is actually negative due to refundable credits that give them a check back from the IRS.
Despite conventional wisdom that the Bush-era tax cuts disproportionately benefited the wealthy, the reality is that the tax burden on the bottom 99 percent has been falling for more than two decades. Indeed, the average tax rate for the bottom 99 percent of taxpayers is now below 10 percent—well below the average for all taxpayers—thanks to years of targeted tax cuts aimed at the middle class. Meanwhile, the top 1 percent of taxpayers still pays an effective tax rate that is roughly twice the average for all taxpayers.
Chapter 2. Taxes + Spending = Redistribution

The central argument in most tax debates in Washington is not about efficiency or economic growth but about the distribution of taxes—which income groups pay more or less of the tax burden. Despite the fact that lawmakers impose taxes in order to spend them on programs intended to benefit their constituents, little attention is given to the distribution of spending programs.

The real question that ought to be asked is, how much do people pay in taxes of all kinds (from gas and income taxes to tariffs and business taxes) versus how much they receive in spending (from welfare and national defense to roads and solar energy subsidies). Some families are net beneficiaries of federal spending, meaning they get back more than $1 for every $1 they pay in federal taxes, while other families are net contributors to government, meaning they get less than $1 back for every $1 they pay in taxes. Once we measure the results for every family, we can calculate how much tax and spending policies combine to redistribute income from some Americans to others.

These findings are particularly relevant to the current tax reform debate because distributional issues are one of the key sticking points to reform proposals that would cut marginal tax rates while broadening the tax base. But tax progressivity is only half the picture because progressivity can be achieved through both taxes and spending. If the result of moving to a flatter, more economically neutral tax code is a slightly lower tax burden on upper-income families, we could still maintain the overall balance of progressivity of the fiscal system by cutting the types of federal spending that benefit high-income families.
Interestingly, the amount of federal spending that families at various income levels receive is not all that different. What does differ considerably is the amount of federal taxes they pay.

Not surprisingly, low-income working families pay very little in federal taxes of all kinds, but they receive considerably more in federal spending benefits. Families earning under roughly $17,000 pay less than $3,000 in total federal taxes, but receive more than $24,000 in federal spending benefits of all kinds. However, it is surprising that middle-income families—those earning between roughly $37,000 and $67,500—also receive more in federal spending benefits than they pay in federal taxes of all kinds. Indeed, middle-income families receive an average of $7,376 more in federal spending than they pay in federal taxes. By contrast, families in the top 20 percent of earners pay $65,573 more in taxes than they receive in all federal spending.
Collectively, families in the bottom three income groups—those earning under $67,456—are net beneficiaries of government spending. This means that as a group, the majority of American families receive more back in government spending than they pay in federal taxes of all kinds.

The lowest-income families receive an average of $8.13 in federal spending for every $1 that they pay in federal taxes, while the next-lowest gets $2.96, and middle-income families receive $1.57. Meanwhile, upper-income families are net contributors to government. Those at the top of the middle-class receive $0.83 back for every dollar they pay in taxes, while high-income families receive $0.25.
Clearly, there are two groups of families in America—those that get more back in spending than they pay in total taxes and those that pay more in taxes than they get back in spending. When we compare the two groups, we find that federal tax and spending policies combine to redistribute more than $1.5 trillion in income from the top 40 percent of American families to the bottom 60 percent.

More than half of this total ($849 billion) goes to the lowest-income families, while another $453 billion flows to the working poor. Middle-income families as a group receive $225 billion in redistributed income from upper-income Americans. The vast majority of this redistributed income is taken from the top 20 percent of families—those earning over $119,698. Of this amount, nearly $650 billion (or 40 percent) is taken from families in the top 1 percent.
Federal, state, and local policies redistribute $2 trillion in income. Prior to redistribution by government, the top 20 percent of families earned 55 percent of the nation’s income. After government’s tax and spending policies, these families earned 39.6 percent of the nation’s income.

The opposite occurs for the majority of Americans. The bottom 20 percent of the population earned 3.1 percent of total income in 2012, but redistribution from all government sources increased their incomes by $1.1 trillion, raising their share of the nation’s income to 11.8 percent. Families in the middle quintile also gained income from redistribution. Initially, these middle-income families earned 14 percent of the nation’s income, but redistribution added $297 billion to their incomes and increased their post-redistribution income share to 16.4 percent.
Chapter 3. Who Benefits from All Those Loopholes, Credits, and Deductions?

At the beginning of 2013, the top income tax rate was raised from 35 percent to 39.6 percent as part of a major budget deal between the White House and leaders in Congress. Changes like this understandably garner a great deal of attention. Less well known, however, are the details of the nation’s so-called “tax expenditures.” These are all of the loopholes, credits, and deductions that individuals and corporations use to lower the amount of tax they pay. This includes everything from the child tax credit and the deduction for charitable contributions to the Earned Income Tax Credit and the ability of a company to deduct part of the cost of a new factory.

First, we need to untangle the two major categories of tax expenditures—those for corporations and those for individuals. Currently the total value of all corporate credits and deductions is about $112 billion a year. That’s a lot of credits and deductions, but it’s only about one-tenth of the total that individuals receive. In addition, while the cost of corporate tax expenditures has remained relatively stable in recent years, the amount given out to individuals has increased significantly.

In particular, lower-income households have been the beneficiaries of the rise of refundable tax credits. These are benefits that directly reduce the amount of tax individuals pay and become a cash payment from the federal government if one’s tax bill is reduced to zero. Refundable tax credits are a large part of why well over one-third of all Americans owe nothing in federal income taxes at the end of the year.

Other credits and deductions primarily benefit high-income households. For example, over 95 percent of taxpayers with incomes over $200,000 take advantage of itemized deductions for things like mortgage interest and charitable contributions, while only 16 percent of taxpayers making $30,000 claim such deductions. The deduction for charitable contributions, for example, overwhelmingly benefits high income taxpayers—almost 60 percent of all charitable contributions deducted on U.S. tax returns are claimed by taxpayers earning over $200,000 per year.
According to the U.S. Treasury, there are currently 169 so-called tax expenditures, or preferences, in the tax code. Interestingly, the congressional Joint Committee on Taxation counts more than 200. However many there are, the Treasury estimates the 2014 dollar value of these preferences at about $1.2 trillion. While many people believe that corporations benefit most from these loopholes, they really don’t. About $1.1 trillion, or 91 percent of all the tax preferences, accrues to individuals rather than corporations.

Additionally, just a handful of the 169 plus provisions account for more than half of the budgetary cost of all individual tax preferences. These include the preferences for employer-provided health insurance, pensions and 401(k)s, mortgage interest, and charitable contributions.
While there may be more than 160 tax preferences in the code, most are small in cost and targeted to discrete missions such as the incentives for adopting children or purchasing hybrid cars. To be sure, lawmakers should wipe the slate clean of any inefficient and obsolete provisions, but the big savings are in just a handful of provisions that touch a wide swath of the American public.

The biggest provision by far in the code is the exclusion of taxes on employer-provided health insurance, with a budgetary cost of $212 billion annually. There are a couple of separate provisions that exclude taxes on pensions and 401(k)s that we have combined here for a “cost” of $176 billion. The mortgage interest deduction is the other substantial preference in the code. The dozen preferences listed here have a total budgetary cost of $828 billion—some 75 percent of the cost of all individual tax preferences.
After the Tax Reform Act of 1986, there were 119 tax preferences. By 2013, there were 169. In real dollar terms, the growth of tax expenditures has been entirely on the individual side of the tax system since 1986. According to Treasury estimates, the tax expenditure budget grew from $844 billion (2013 dollars) in 1986 to $1.2 trillion in 2013, an increase of 44 percent. Over the same period, individual tax expenditures grew from $685 billion to $1.1 trillion. The biggest driver of this growth has been the cost of employer-provided health insurance. Meanwhile, corporate tax expenditures shrank from $159 billion in 1986 to $108 billion in 2013. Corporate tax expenditures are now less than 9 percent of the tax expenditure budget, which is lower than at any time since 1986.
When filling out their tax returns, taxpayers can choose between claiming a standard deduction (which in 2013 was $6,100 for a single filer and $12,200 for married couples) or itemizing their deductions—whichever is larger. The value of deductions depend on the top rate a taxpayer pays at. For example, a $1,000 deduction is worth $150 for someone in the 15 percent bracket, but worth $396 for someone in the top 39.6 percent bracket.

The percentage of tax filers who itemize increases as we move up the income scale. Only about half of taxpayers earning between $50,000 and $75,000 claim itemized deductions, but nearly 100 percent of taxpayers earning above $200,000 itemize.
Despite the fact that lawmakers have enacted various provisions over the years to limit the value of tax deductions for high-income taxpayers, taxpayers earning over $200,000 still manage to claim a disproportionately large share of some key tax breaks. While taxpayers earning over $200,000 comprise roughly 13 percent of all taxpayers who itemize, they claim about 28 percent of all itemized deductions. According to calculations by the Joint Committee on Taxation, in 2012, these high-income taxpayers claimed 35 percent of all mortgage interest deducted, 55 percent of state and local taxes deducted, and 57 percent of charitable contributions deducted.
Over the past 25 years, lawmakers have increasingly turned to using targeted tax credits to benefit key constituents—such as families with children—or to incentivize certain economic behavior—such as replacing the windows in your home. Tax credits differ from deductions in that they directly lower your tax liability rather than reduce your taxable income. Some tax credits, such as the Earned Income Tax Credit, the Child Credit, and some educational credits are refundable, meaning you can get a check from the IRS even if you owe no income taxes. Millions of taxpayers receive such refundable checks. The combined cost of these tax credits peaked in 2010 at $233 billion (in today’s dollars) and has since dropped to $176 billion. If tax credits were classified as a spending program, they would be one of the largest domestic programs in the budget.
The percentage of nonpayers (taxpayers who owe zero income taxes after taking their credits and deductions) began to climb significantly after the Tax Reform Act of 1986, which increased the value of the standard deduction and nearly doubled the size of the personal exemption. But the number of nonpayers has soared in recent years because of the expansion and creation of credits such as the Earned Income Tax Credit, the Child Credit, and various energy and education credits.

In 2011, roughly 54 million federal income tax filers had no income tax liability after deductions and credits. This amounts to 37 percent of the roughly 145 million tax returns filed that year. While high, this is not as high as 2009 when 58 million income tax filers, nearly 42 percent, were nonpayers. By contrast, the low point for nonpayers was 1969, when only 16 percent of filers had no income tax liability.
About half of all nonpayers receive refundable tax credits even though they have no income tax liability. This means that, in addition to recouping every dollar withheld from their paycheck during the year, they also receive a subsidy check from the IRS. The Congressional Budget Office now estimates that, because of the large amount of refundable tax credits, the bottom 40 percent of households now have negative effective tax rates. Remarkably, the effective tax rate for middle-income households is nearing zero because of the recent expansion of tax credits. The net effect of these trends is that virtually the entire income tax burden is now being borne by the two highest groups of taxpayers.
Chapter 4. The Changing Face of America’s Tax Returns

In Washington, debates about economic policy often begin with the premise that tax policies should either help, or at least protect, the middle class. By “middle class,” most politicians tend to mean the median taxpayers or those in the statistical middle—taxpayers earning roughly $30,000 to $70,000 per year.

The composition of this group of taxpayers, however, has changed dramatically over the past fifty years. Whereas the middle class was once overwhelmingly comprised of married couples, it is now mostly single individuals and single-headed households. Indeed, the taxpayers we now find in the lower income groups tend to be younger workers just beginning their careers, retirees, or less-educated workers.

By contrast, more and more married couples are now clustered toward the top of the income scale because they are two-earner couples who are older, better educated, and often have business income in addition to their wages and salaries. They could be called the entrepreneurial middle-class and tend to make over $100,000.

These facts sometimes get overshadowed by the inability of Americans to agree on who actually is middle class. When asked by pollsters what economic class they are part of, most Americans define themselves as middle class. Of the top 20 percent of earners who might reasonably consider themselves upper class, only 2 percent actually identify with that category. This disconnect has profound implications for the political debate over who should pay what in taxes.
When we think of middle class families, we think of married couples with children such as June and Ward Cleaver from *Leave It to Beaver*. Once upon a time, June and Ward represented most taxpayers, but demographic changes have made those notions obsolete. In 1960, more than 65 percent of taxpayers were married couples, while single filers comprised the remaining 35 percent. Those figures are now nearly reversed. Because the majority of taxpayers today are single filers, the typical taxpayer looks more like Phoebe and Joey from *Friends*. As a result, lawmakers’ efforts to use tax policy to help middle-income taxpayers are now missing their targets.
While it is clear from the chart that the husband-as-sole-breadwinner stereotypical family of the 1960s was probably not the norm then, it is most certainly less so now. Mothers worked during the 1960s but fewer than half of all married couples during that era were dual-earners. Today, that number has risen to 66 percent, more than twice the number of sole-earner married couples. This means that a large share of married couple tax returns have two incomes and thus are now clustered in the upper income groups facing the highest marginal tax rates.
All evidence indicates that one of the biggest factors separating high-income from low-income households is the number of workers in each. The further we look up the income scale, the more likely we are to find two and even three income households (with mom, dad, and children working). For example, here we see that 49 percent of households earning between $50,000 and $55,000 have only one worker, whereas 75 percent of the households making over $200,000 have two or more workers. Two single, middle-income people can become rich on paper simply by saying “I do.”
One of the most overlooked explanations for the difference in income between taxpayers is the issue of life cycle. Our income tends to grow as we mature and gain work experience, reaching its peak as we near retirement. As this chart illustrates, the average income for taxpayers age 55 to 65 is nearly $82,000—well above the $57,606 average for all taxpayers. Even taxpayers over age 65 make more than the national average. As the Baby Boomer generation moves into its peak earnings years, there will be more high-income taxpayers than younger low-income ones, giving the appearance of rising inequality.
This chart illustrates the aging of America’s taxpayers over a very short span of 14 years as the Baby Boomer generation moved through adulthood into their pre-retirement work years. In 1997, just 39 percent of all taxpayers were older than age 45. Today, nearly half (48 percent) are over 45 and that figure will likely continue to climb as more and more Baby Boomers get closer to retirement. Indeed, in 1997, just 10 percent of taxpayers were between the ages of 55 and 65. Today, 15 percent of taxpayers are in that age group. Moreover, in 1997, taxpayers over age 45 earned just over half of all income (53 percent). Today, they earn 62 percent of all income.
As Americans age, more and more of the tax burden will be borne by older taxpayers. In 1997, 61 percent of all income taxes were paid by taxpayers over age 45. Today, that burden has jumped to 74 percent. The biggest increase has been in the tax share paid by taxpayers between 55 and 65. In 1997, this group paid 18 percent of all income taxes. Today, they are paying 27 percent of all income taxes. Those over age 65 are now paying nearly one-fifth of all income taxes. Naturally, this raises concerns over the ability of this older generation to save for their own retirement while financing the lion’s share of the cost of government, especially as Washington continues to raise taxes on the “rich” to close rising deficits.
One of the biggest contributors to rising inequality in America today is the growing earnings gulf between workers with college degrees and those without. Indeed, the median income for all households was $51,244 in 2011. By contrast, the median income for a household headed by a worker with a four-year college degree was $78,251, more than 50 percent above the typical household. Those with professional degrees earn more than twice the median household income.

At the other end of the scale, the median income for a household headed by a worker with only a high school diploma was nearly 25 percent less than the typical household—$39,420. The incomes of households headed by workers without high school diplomas is just half as much as the typical household and about one-third as much as someone with a college degree.
Perhaps nothing better illustrates the causes of income inequality in America today than the vast differences in educational attainment between high-income households and low-income households. Nearly 70 percent of Americans at the bottom end of the income scale have a high school degree or less, while just 10 percent have a college degree or more. At about $62,000 of income, a roughly equal percentage of workers have a high school degree (35 percent) as have a college degree (34 percent). However, at the top end of the income scale, nearly 80 percent of high-income households have a bachelor’s degree or higher, while less than 10 percent have only a high school diploma. Raising taxes on high-income taxpayers will not correct this education-based income disparity.
According to some sources, the United States has not been this economically unequal since the days of the Great Depression. Many attribute this perceived rise in inequality to record CEO pay packages, Wall Street bonuses, and superstar athletes and entertainers. However, there is a considerable amount of evidence that inequality is not a steady state and that it tends to rise and fall with the business cycle.

Moreover, America is still the land in which anyone with initiative can improve their station in life fairly quickly. Longitudinal studies show that people move up and down the income scale frequently. Even over a short eight-year window, nearly 60 percent of low-income taxpayers move up the income ladder, while about 40 percent of high-income taxpayers moved into lower income groups.

In reality, inequality is no worse today than it was during the Clinton administration. Whatever gains have been made by the top 1 percent of Americans have not come at the expense of those of us in the bottom 99 percent. In fact, the incomes of the 99 percent are actually much higher, in inflation-adjusted terms, than they were two decades ago.

The most significant characteristic we see looking at the incomes of the highest-earning Americans is their volatility. At the very top of the income spectrum, incomes rise much faster during boom times but also plummet dramatically during economic downturns. Given that the households with the most income also likely take higher investment risks, this is exactly what we would expect.

Not only do incomes at the top fall faster during recessions, but the status of being a millionaire itself is fleeting for the many Americans who have managed to achieve it. The number of millionaire tax returns more than doubled in the five years leading up to 2007, but then dropped by 40 percent in just the next two years. Being a wealthy American one year is no guarantee you will be one the next year, yet Washington tries to tax the rich as though they were monolithic.
While America certainly has its share of people in chronic poverty and those with vast wealth, we are an economically mobile society. IRS data tracking the same group of taxpayers between 1999 and 2007 showed that Americans can move from one economic group to another fairly quickly. For example, nearly 60 percent of taxpayers who began in the lowest income group in 1999 moved to a higher income group by 2007. Conversely, roughly 40 percent of taxpayers who started out in the highest income group moved to lower income groups within eight years.
There is a pervasive belief that the gains of successful Americans come at the expense of everyone else. However, if anything, the data suggests that the incomes of all Americans are higher than they were twenty years ago after adjusting for inflation, and that everyone's incomes tend to rise and fall with the business cycle. Between 1987 and 2010, the bottom 50 percent’s real income grew by 25 percent, middle-income Americans' by 46 percent, and upper-middle-income Americans' by 56 percent.

Clearly, the incomes of the top 1 percent tend to rise more and fall more during the business cycle because most of their income comes from business and investments. Indeed, the top 1 percent’s income fell 26 percent in real terms during the recession, far more than any other income group.
Listening to some politicians, you would think that millionaires were some monolithic group that can be taxed at will. But IRS data clearly shows that the number of millionaire tax returns fluctuates wildly each year, largely due to changes in the business cycle. Indeed, between 2002 and 2007, the number of millionaire tax returns more than doubled to a record 392,220. However, thanks to the recession, the number of millionaire tax returns fell by 40 percent between 2007 and 2009, or more than 155,000. Moreover, the recession reduced the total amount of income reported on millionaire returns by 48 percent and the amount of income taxes they paid by 43 percent.
For most Americans, incomes tend to rise with age. Thus, it is not surprising that in 2011, more than 80 percent of millionaires were older than age 45, and close to half of all millionaires (48 percent) were older than age 55. In fact, there are still more millionaires over the age of 65 than between the ages of 35 and 45. Moreover, despite the publicity given to the growing number of young millionaire athletes, celebrities, and entrepreneurs, only about 3 percent of all million-dollar tax returns are filed by taxpayers under the age of 35.
Numerous studies have shown that millionaire status appears to be fleeting or episodic, because many people become millionaires as the result of a one-time event such as the sale of a business or stock. A recent Tax Foundation study found that between 1999 and 2007, about 675,000 taxpayers earned over $1 million for at least one year. Of these taxpayers, 50 percent (about 338,000 taxpayers) were a millionaire in only one year, while another 15 percent were millionaires for two years. By contrast, just 6 percent (38,000 taxpayers) remained millionaires in all nine years.
Because the U.S. tax code is divided between sections that apply to individuals and those that apply to corporations, many Americans have assumed that there is no overlap between households and businesses when it comes to taxes. Anyone who has ever been part of a small business venture can testify that this is far from the truth.

More than 30 million U.S. businesses are organized as partnerships, sole proprietorships, LLCs, or S corporations, and the income from those entities is claimed by the owners on their individual tax returns. In fact, since 2005, the total amount of net business income claimed on individual returns has exceeded the net income claimed by the traditional C corporations that issue publicly-traded stock.

Understanding this overlap is key for comprehensive tax reform, because it reminds us that we can’t look at business and household income as unrelated sources. Not only is the majority of the nation’s business income derived from the non-corporate side of the ledger, but the overwhelming majority of that is claimed by high-income households. Thus, the impulse to raise tax rates on those in the top brackets—which we have seen gain currency during the recent recession—hurts investment, jobs, and growth in a way that often goes unrecognized.
What sets the entrepreneurial middle class apart from other taxpayers is that they derive a large share of their overall earnings from pass-through businesses such as S corporations, LLCs, and partnerships. These pass-through business owners pay their business taxes on their individual tax returns. Since the 1980s, the number of traditional C corporations has shrunk while the total number of pass-through businesses such as S corporations, partnerships, and sole proprietorships has tripled to over 30 million in total. Today, there are 1.7 million traditional C corporations, compared to 7.4 million partnerships and S corporations, and 23 million sole proprietorships.
Because of the remarkable growth of pass-through businesses over the past two decades, there is now more net business income reported on individual income tax returns than on traditional C corporation returns. The U.S. Treasury has estimated that as much as 40 percent of all business taxes are now paid on individual tax returns rather than on corporate tax returns. It is interesting to note that pass-through business income tends to be far more stable than traditional corporate income. Since the peak of the last business cycle in 2006, non-corporate income has fallen by just 8 percent, while corporate income has fallen off by 26 percent.
It is often said that raising top tax rates will have little effect on business activity because only 2 percent of taxpayers with business income will be impacted. However, the more economically meaningful statistic is how much overall business income will be taxed at the highest rates. In 2011, the vast majority (70 percent) of pass-through business income was reported by taxpayers earning more than $200,000. Millionaire tax returns earned 34 percent of all private business income while taxpayers with incomes below $100,000 earned just 14 percent.
For all of the success of major U.S. corporations around the world and the prosperity they have created here at home, many Americans harbor a suspicion that the biggest U.S. companies don’t pay their fair share of taxes. High-profile reports on a handful of companies that have ended up with low effective tax rates have come to define much of the popular perception of how corporate America pays taxes.

As it turns out, some corporations do pay far more in taxes than others, but that is due to an extraordinarily complex tax code loaded with exemptions, credits, deductions, and other provisions. Financial managers in corporate America understandably try to minimize their companies’ liabilities, but no group of high-priced lawyers and accountants can cut a tax bill lower than Congress has authorized the code to allow.

The largest U.S. corporations not only have their tax returns closely monitored, but many even have teams of full-time IRS agents stationed in their offices, auditing and looking over the shoulders of their tax departments throughout the year. Some of the tax planning strategies currently employed by major corporations have been controversial and have even generated calls that they should be disallowed. However, actual instances of tax evasion by major corporations are rare.

In the process of simplifying and reforming the corporate tax code, we need to see what U.S. companies really pay—both at home and to foreign governments—and how the current code has created a radically uneven playing field for different firms and sectors.
In today’s globalized world, U.S. corporations are increasingly at a competitive disadvantage. They currently face the highest statutory corporate income tax rate in the world at 39.1 percent. This overall rate is a combination of our 35 percent federal rate and the average rate levied by U.S. states. Corporations headquartered in the 33 other industrialized countries that make up the Organization for Economic Cooperation and Development (OECD), however, face an average rate of 25 percent. Even corporations in high-tax European countries such as Belgium (34 percent), France (34.4 percent), and Sweden (22 percent) face much lower rates than those in the United States. Our largest trading partners—Canada, Japan, and the United Kingdom—have each cut their corporate tax rates over the past few years to become more competitive.
The U.S. corporate tax rate has remained nearly unchanged for more than 25 years. Meanwhile, lawmakers in the 33 other OECD industrial nations have repeatedly cut their corporate income tax rates to make their economies more competitive and more attractive to investment. The combined federal and state corporate tax rate in the U.S. remains at 39.1 percent while the simple average of the OECD is 25 percent. China’s corporate income tax rate is also 25 percent. Even after adjusting for country size, the U.S. rate is about 10 percentage points above the OECD average. When it comes to corporate tax reform, the U.S. is falling behind by standing still.
In 2010, U.S. corporations paid about $223 billion in income taxes on slightly more than $1 trillion in taxable income. However, the vast majority of this income and taxes is attributable to the roughly 2,700 corporations with assets above $2.5 billion. Indeed, these corporations earned 77 percent of total corporate taxable income in 2010 and account for 69 percent of all corporate income taxes paid in the United States. Meanwhile, mid-size companies with assets between $500 million and $2.5 billion in assets earned 11 percent of corporate income and paid 14 percent of corporate income taxes.
Although many reports claim that U.S. corporations are not paying their “fair share” in taxes, the reality is far different. According to IRS data, corporations pay a substantial amount in income, sales, and various other taxes, not only to the U.S. government, but also to state, local, and foreign governments. In 1994, corporations paid $610 billion (2010 dollars) in total taxes compared to their total corporate taxable income of $724 billion. As the economy grew, total taxes paid increased, peaking in 2006 at $920 billion. Most recently, U.S. corporations paid approximately $723 billion in taxes to all levels of government, compared to $1 trillion in taxable income.
Although every corporation faces the same federal statutory tax rate of 35 percent, they pay vastly different effective tax rates after accounting for differences in profitability, the amount of business done overseas, and different tax benefits in the tax code. For instance, in 2010, the manufacturing industry had a low effective tax rate of 15 percent. In part, this was due to the short-term stimulus policy that allowed businesses to immediately expense large purchases. Also, many of these firms do a substantial amount of business overseas and are allowed to credit their foreign taxes against their U.S. tax bill. By contrast, many service and retail firms have relatively high effective tax rates because they have very few large write-offs and most of their sales are domestic, so they can’t use foreign tax credits to lower their U.S. tax bill. Therefore, their effective rates are closer to the statutory rate of 35 percent.
Chapter 8. The Economics of Tax Reform

Given the economic and demographic data we have seen so far, how do we go about overhauling the U.S. tax code? As in any complex undertaking, it helps to start with a goal. Despite the partisan and ideological divides we see in Washington, the tax reform debate ultimately boils down to one question: which changes in the law are going to produce the greatest prosperity for all Americans?

In practical terms, the question for policymakers then becomes how to modernize the federal tax code in a way that maximizes economic growth. We know that reducing the overall tax burden leads to faster growth and that a growing economy raises our standard of living, ultimately providing more jobs, higher wages, and greater economic opportunities.

This would seem to set us on a fairly clear path, but we face some roadblocks. One roadblock has to do with Washington’s requirement that a new tax system must raise as much revenues as the old tax system. What this means in political terms is that any revenues lost from cutting tax rates for most Americans must be balanced with higher taxes on other Americans or by eliminating some of their tax deductions.

To some, such a tradeoff makes sense because there is a general belief that a tax system that has lower rates and fewer deductions will be more pro-growth tax than our current system. This sounds good in theory but is more complicated in practice because not every deduction in the current tax code is a loophole that should be abolished.

There are many provisions in the current tax code that protect our savings and investments from double taxation and help make the tax system more pro-growth. Eliminating these provisions can stifle economic growth even when paired with lower tax rates.

Measuring the effect of these policies on economic growth is key to crafting the right policies. However, Congress relies on models that assume tax changes have little or no impact on the economy. This simply isn’t true. The Tax Foundation’s Taxes and Growth (TAG) model does measure the impact of tax changes on our dynamic economy and can help guide lawmakers toward smarter solutions.
The general consensus among tax reformers is that the top individual and corporate tax rates should be lowered to at least 25 percent. But before setting off to simplify the tax code, it is important to first understand the economic benefits of cutting tax rates across-the-board. Using our Taxes and Growth Model, we found that the dynamic effects of cutting both the corporate and individual tax rates to 25 percent would be substantial—both individually and in combination. Each rate cut would boost GDP by over 2 percent and together by 4.7 percent. Combined, the rate cuts would boost investment in plant and equipment by 11.53 percent which, in turn, would increase productivity and raise wages by nearly 3 percent.
The total budgetary cost of all tax expenditures and preferences in 2013 was roughly $1.2 trillion. Generally speaking, we can separate them into three groups—provisions that are corporate welfare in nature (preferences for hybrid vehicles, windmills, and credit unions), those that are intended to have social benefits (the Earned Income Tax Credit, Child Credit, and charitable deduction), and those that prevent double taxation or promote neutrality (401(k)s and pensions, lower capital gains rates, and business expensing). Just 3 percent can be called corporate welfare, while another 37 percent fall into the category of social welfare policy. The remaining 60 percent of tax preferences do in some way prevent double-taxation or protect savings and investment. While many of these could be reformed, eliminating them outright could be economically harmful.
Our analysis shows that cutting the corporate tax rate from its current 35 percent rate to 25 percent would boost GDP, investment in plant and equipment, and workers’ wages. But by some accounts, the only way to cut the rate without losing revenues for the Treasury is to eliminate virtually every tax preference in the corporate code. Our TAG model shows that trading nearly every tax preference for a 25 percent rate would undo all the benefits of the lower rate. Indeed, such a plan would reduce GDP, investment, and wages. The reason for these negative effects is because so many of the eighty or so corporate tax provisions encourage capital investment (especially such things as accelerated business write-offs and the R&D tax credit). Eliminating these provisions negates the benefits of a lower tax rate.
While many lawmakers understandably want to wipe the tax code clean and start out with a blank slate, they need to understand the economic impact of eliminating various tax breaks and whether trading them off for lower tax rates is good or bad for growth. Eliminating some preferences, such as the lower rates on capital gains and dividends or the mortgage interest deduction, can produce very negative economic effects. Raising capital gains and dividend rates could lower GDP by nearly $1 trillion, an adverse impact which would hardly be lessened by also cutting personal tax rates. Eliminating other provisions, such as the exclusion for employer-provided health insurance and the charitable deduction, may lower GDP at first, but would boost GDP if paired with lower tax rates. Eliminating the Child Credit and various education credits would be good for growth with or without being paired with rates cuts.
Conclusion

The United States tax system is in desperate need of simplification and reform. The relentless growth of credits and deductions over the past twenty years has made the IRS a super-agency, engaged in policies as unrelated as delivering welfare benefits and subsidizing the purchase of electric cars.

While tax cuts will always curry more favor with voters than creating new spending programs, Washington needs to call a truce on using the tax code for social or economic goals. The consequence of trying to micromanage the economy through the tax code leads to tax policy that is overly complex and burdensome for taxpayers, businesses, and the economy. Were we starting from scratch, this is not the type of tax system we would create.

A smarter tax system would fund the government in a way that doesn’t restrict the economy but instead frees it to thrive and allows taxpayers to prosper with it. This type of reform promotes prosperity in a principled manner, through simple, transparent, and neutral taxes. These principles and this mindset should guide tax reform.

Fundamental tax reform can achieve our goals. It can restore the nation’s competitiveness and put us on a path to growth for the future. Not only will this improve living standards in America, it will improve the nation’s fiscal health. That is a win for every American.
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About the Tax Foundation

Since 1937, the Tax Foundation has been a constant advocate for smarter tax policy. We are trusted as the leading voice for changing the debate on tax policy through educating taxpayers, expert analysis, coalition building, engaging lawmakers, and more.
Tax reform is in the air in Washington these days. It may take time to come to fruition, but there is growing bipartisan agreement that the tax code is too complicated, burdensome, and uncompetitive, and is undermining our economic potential.

We know we need tax reform. But before we reform the tax code, we need to understand the tax code. We need to know who pays income taxes and who doesn’t. We need to be aware of the demographic changes happening in America. We need to see how our tax rates compare internationally. We need to know who benefits from the current tangle of credits and deductions. We then need to understand the economic effects of wiping the slate clean and whether we would be better off trading tax expenditures for lower tax rates.

What is missing from the process is a real sense of who the people behind the tax returns are. We’ve compiled this chart book not only to put a face on America’s taxpayers but also to provide all of the must-know background information on the key issues of the tax reform debate.