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TAX FEATURES

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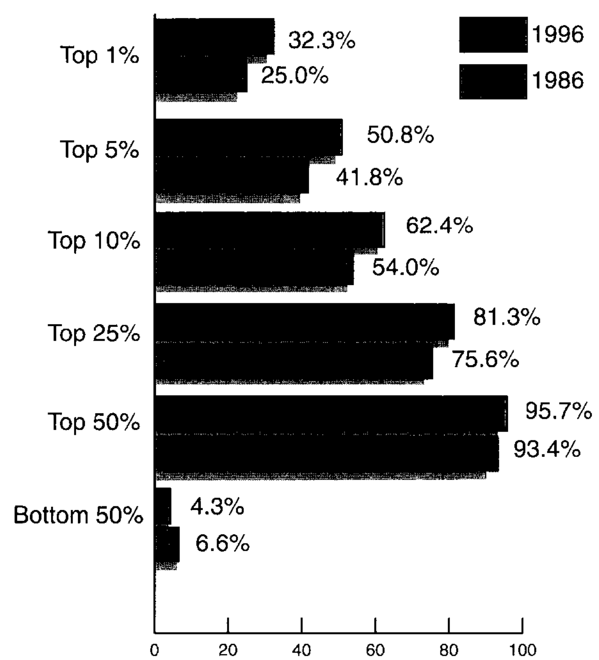
Five Percent of Taxpayers Pay Over Half Of Federal Individual Income Taxes

The latest data from the Internal Revenue Service show that more than half of all federal individual income taxes, 50.8 percent, are paid by the five percent of taxpayers who earn the most. In 1996, the latest year for which data is available, this top five percent consisted of 6.0 million earners whose adjusted gross incomes (AGI) were higher than $101,202.

Federal Individual Income Taxes by Income Group
1986 and 1996



Source: Tax Foundation.

Even among this prosperous group, the highest earners paid the lion's share (see figure at left). The top one percent of earners in the country is paying close to a third of all the taxes collected. That's approximately 1.2 million earners who paid 32.3 percent of 1996's federal individual income taxes.

A time series analysis of the data shows that since 1980 the share of federal individual income taxes borne by the top five percent has increased markedly. In 1980 these individuals paid 36.8 percent of federal individual income taxes, a hefty share but significantly less than their 50.8 percent share in 1996. Naturally, this shift has resulted in a corresponding decline in the share of the tax burden shouldered by the remaining 95 percent of taxpayers.

Federal Individual Income Taxes Paid by Income Group

The table on page 2 presents a breakdown of total federal individual income tax pay-

Income Taxes *continued on p. 2*

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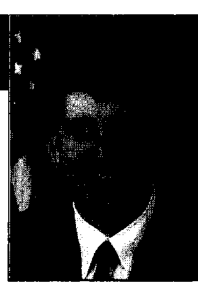

Acting to Rescue America's Marine Industry from Overtaxation

Representative Patrick J. Kennedy (D-RI)

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Income Taxes *from p. 1*

ments by income percentile. It shows that the 32.3 percent share paid in 1996 by the top one percent of income earners — those with AGIs over $229,230 — was considerably higher than the 25.0 percent they paid in 1986. Similarly, the 50.8 percent paid by the top five percent of income earners in 1996 was nine percentage points higher than the share paid by the same percentile of filers in 1986.

Likewise, in 1996, 62.4 percent of federal individual income taxes were collected from individuals in the top 10 percent of income earners, or those with incomes over $74,978. In 1986 just over half of all federal individual income taxes were collected from filers in this percentile. Meanwhile, the top half of the income scale paid 95.7 percent of 1996's federal individual income tax burden. These earners had AGIs of at least $23,160. In 1986 this group bore 93.4 percent of this burden.

This decade-long shift in the tax burden toward higher earners has obviously lightened the load on lower income filers. In 1986, individuals in the lower half of income earners paid 6.6 percent of total federal individual income taxes. By 1996 this figure had dropped to just 4.3 percent.

Money Earned vs. Taxes Paid: Comparing Income Classes

The table presents the income shares as well as the tax shares of the different income groups. While high-income earners claim relatively large shares of total income, they pay even greater shares of the federal individual income tax burden. For example, individuals in the top one percent of tax filers earned 16.0 percent of total AGI in 1996, but they paid 32.3 percent of federal individual income taxes during that year. The average effective federal individual income tax rate for this group was 28.7 percent. Similarly, tax filers in the top five percent of income earners earned 30.4 percent of total AGI during 1996, but paid 50.8 percent of total federal income collections. The average effective tax rate for this group was 23.9 percent.

While the top half of the income scale earned 85.9 percent of total AGI, it paid 95.7 percent of the taxes at an average effective tax rate of 15.9 percent. The bottom half earned 14.1 percent of total AGI, and paid 4.3 percent of total federal individual income taxes. Their average effective federal individual income tax rate was 4.4 percent.

"Even among the top-earning five percent of taxpayers, the highest earners paid the lion's share. The top one percent of earners in the country is paying close to a third of all the taxes collected. That's approximately 1.2 million earners who paid 32.3 percent of 1996's federal individual income taxes."

Federal Individual Income Tax Return Data
1986 & 1996

1986

	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	102,088	$2,524,124	$360,566	100.0%	100.0%	-	14.3%
Top 1%	1,021	285,197	90,236	11.3	25.0	above $118,818	31.6
Top 5%	5,104	608,467	150,750	24.1	41.8	above $62,377	24.8
Top 10%	10,209	886,510	194,821	35.1	54.0	above $48,656	22.0
Top 25%	25,522	1,490,173	272,748	59.0	75.6	above $32,242	18.3
Top 50%	51,044	2,103,569	336,926	83.3	93.4	above $17,302	16.0
Bottom 50%	51,044	420,555	23,640	16.7	6.6	below $17,302	5.6

1996

	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	119,442	$4,590,527	$655,420	100.0%	100.0%	-	14.3%
Top 1%	1,194	736,340	211,354	16.0	32.3	above $229,230	28.7
Top 5%	5,972	1,393,795	332,802	30.4	50.8	above $101,202	23.9
Top 10%	11,944	1,909,149	408,783	41.6	62.4	above $74,981	21.4
Top 25%	29,860	2,952,604	532,563	64.3	81.3	above $45,833	18.0
Top 50%	59,721	3,944,386	626,959	85.9	95.7	above $23,160	15.9
Bottom 50%	59,721	646,141	28,461	14.1	4.3	below $23,160	4.4

New Foundation Report Charts 100 Years Of Public Sector Spending

A new Special Report from the Tax Foundation entitled *The Growth of Public Sector Spending in the Twentieth Century* charts the steadily growing involvement of government in the U.S. economy since the beginning of the 20th century. Author Brandon R. Julio examines several indicators, concentrating especially on the fraction of the overall economy that is comprised of government expenditures.

Figure 1 below and Figure 3 on page 6 illustrate the growth of total government expenditures as a percent of GDP since the beginning of the century. In 1900 government expenditures totalled 8.2 percent of GDP. By 1997, this figure had nearly quadrupled to 31.1 percent.

The composition of government expenditures has also changed dramatically over time. At the turn of the century most government spending was used to pay for education and training, physical resources, and national defense. Today most governmental activity involves transferring income from one group to another. This year transfer programs are expected to account for 42.4 percent of government expenditures, a figure that was just 2.0 percent in 1900.

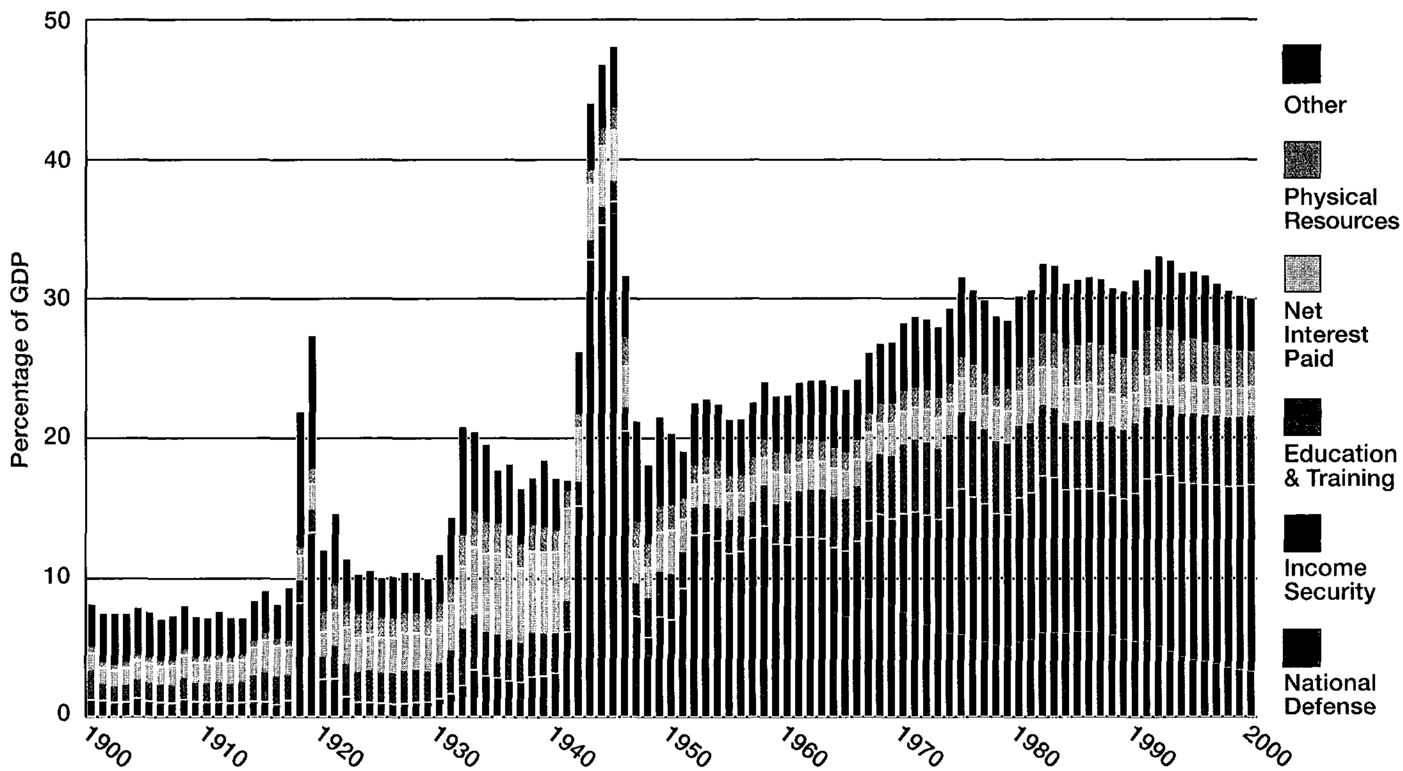
The budgetary authority of the various levels of government has been transformed since 1900. At that time, the bulk of government spending, 62.2 percent, took place at the state and local levels. Today the federal government spends more than twice as much as all of the state and local governments combined.

Federal Expenditures

Federal expenditures as a percentage of GDP have increased almost seven-fold since the turn of the century. They have risen from 3.1 percent of GDP in 1900 to approximately 21.2 percent in 1998 (see Figure 2 on page 5). While federal expenditures are expected to grow in absolute terms over the next couple of years, both the

Gov't Spending *continued on p. 5*

Figure 1
Total Government Current Expenditures by Type As a Percentage of Gross Domestic Product
1900 - 2000



Source: Tax Foundation

FRONT & CENTER

Acting to Rescue America's Marine Industry from Overtaxation

By Rep. Patrick J. Kennedy (D-RI)

While everyone in my home state of Rhode Island recognizes the importance of the marine industry to our economic prosperity, I think the nation as a whole may not appreciate how large and vital this industry has become.

Nationally, the marine industry employs more than 600,000 people, and nearly 100,000 of these jobs are related to the manufacturing, sale and servicing of luxury yachts. In fact, the industry has surpassed the U.S. steel industry in total employment.

The past several years have been a trial for the marine industry. We survived a nearly fatal 10 percent luxury excise tax that was imposed on all new boats retailing for more than $100,000. Since its repeal, the industry has rebounded, and the results of a recent economic study show how far.

The East Bay Economic Initiative reports that employment in the marine industry has increased by 130 percent since 1992. Even by the recent standards, that is a robust pace. Also, there has been an almost 50 percent increase in revenues from this industry recently, proving that even from the Treasury's point of view, eliminating the luxury tax on boats was a wise thing to do.

But while we have rightly repealed the luxury tax, the U.S. falls way behind other countries in supporting the boat manufacturing industry. In 1996, exports of American-made boats was about $650 million, a 4 percent decline from 1995. That same year, imports of foreign-made boats were almost $1 billion, for a 32 percent trade imbalance.

Therefore, I took the next step towards putting this industry on the fast track to expanded economic development by introducing H.R. 3536, The Boat Building Investment Act of 1998. While the crush of election-year politicking prevented its enactment in the 105th Congress, I will begin 1999 by reintroducing it.

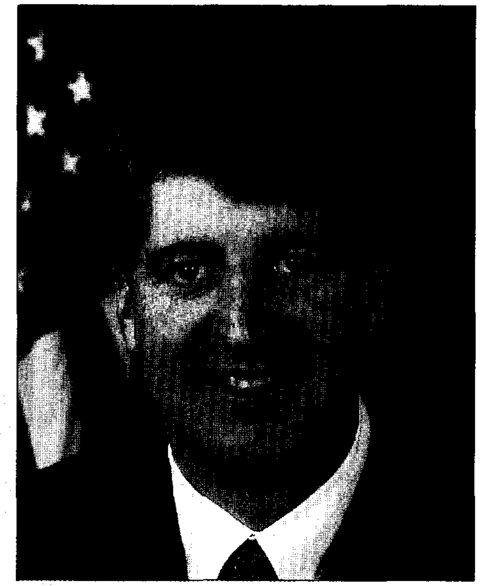
The centerpiece of the legislation is a 20-percent tax credit to anyone who buys a new custom luxury vessel, of at least 50 feet in length, in the United States. For example, if an individual purchases a $250,000 custom yacht, that person will receive a credit against his federal income taxes of $50,000. The credit, which will be capped at $2 million in the legislation I propose next year, will only be available if the vessel is documented, registered, and maintained in the U.S. The federal government will recapture all tax credits if the owner sells or re-registers the vessel outside of the United States.

The bill's centerpiece is a 20-percent tax credit for buying a new 50-foot custom luxury vessel in the United States.

Worldwide, the market for recreational boats over 50 feet is estimated at about $20 billion, so this is a huge and growing market, and we want to be sure American boat builders are competing successfully. And as anyone in the industry will tell you, the costs of maintaining and storing a vessel are significant. Therefore, the multiplier by way of tourism is profound.

The building of yachts is labor intensive, with the average 150-foot custom yacht accounting for 200,000 man-hours. Marine architects, shipwrights, skilled wood and fiberglass workers, and engineers are just some of the quality jobs involved that pay an average of $30,000 per year. Further, for every marine manufacturing job, there are two jobs created in marine retailing and service. Clearly, we can afford to stimulate this activity with the tax code.

Let's be clear here. This is not the type of initiative that I am normally



involved in. All the targeted tax cuts that I have supported have been for educational, low-income housing and health-related expenses. But after a good look at the numbers in the East Bay Economic Initiative report, and considering what these revenues would mean to our economy, including thousands of working families, I knew that it was the right thing to do.

Simply put, this tax incentive will create jobs in the U.S. that will never exist here if our own citizens go overseas to buy luxury custom boats or choose not to maintain them here in our country. I see no economic benefit to our nation as far as tax revenues, business profits, employment, or tourism dollars if we do not take action.

The legislation also calls for a yearly appropriation of $25 million to the Department of Commerce to promote U.S. boat sales abroad and to provide specialized education and training for workers who construct luxury vessels.

European governments have been sponsoring their boat building industries for years, and until this legislation, all we have been sponsoring is lost opportunities. Passing H.R. 3536 would be a good way for the 106th Congress to start the new year.

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

Government Spending *from p. 3*

Office of Management and Budget and the Congressional Budget Office project that they will grow more slowly than the economy as a whole. As a result, federal expenditures as a percent of GDP are expected to decline slightly over the next two years. In fact, the fraction of GDP made up of all government spending is expected to dip to 30.0 percent by 2000.

Many of the changes in the size and structure of federal spending can be traced to major historical events of the last century. Wars, the initiation of new federal programs, as well as the state of the economy have led to changes in federal expenditures over time.

World Wars I and II caused huge increases in national defense spending and federal interest payments resulting from the issuance of war bonds. The Great Depression and the New Deal resulted in burgeoning expenditures on income support.

During the 1950s and 1960s a trend emerged that would characterize federal budget policy through the end of the century. The share of the federal budget allotted to national defense gradually declined while income support, social security, and welfare ballooned. Between 1953 and 1965 defense spending dropped from 10.9 percent of GDP to 7.3 percent. Conversely, total federal income support, social security, and welfare rose from 1.9 percent of GDP to 4.2 percent. Other federal spending remained relatively constant in relation to GDP during this period.

The most significant departures from this pattern during the last 45 years were boosts in defense spending during the Vietnam War, the Reagan era, and the Persian Gulf War. The creation of Medicare, Medicaid, and a host of smaller programs during the 1960s dramatically accelerated the growth of federal spending on income support programs.

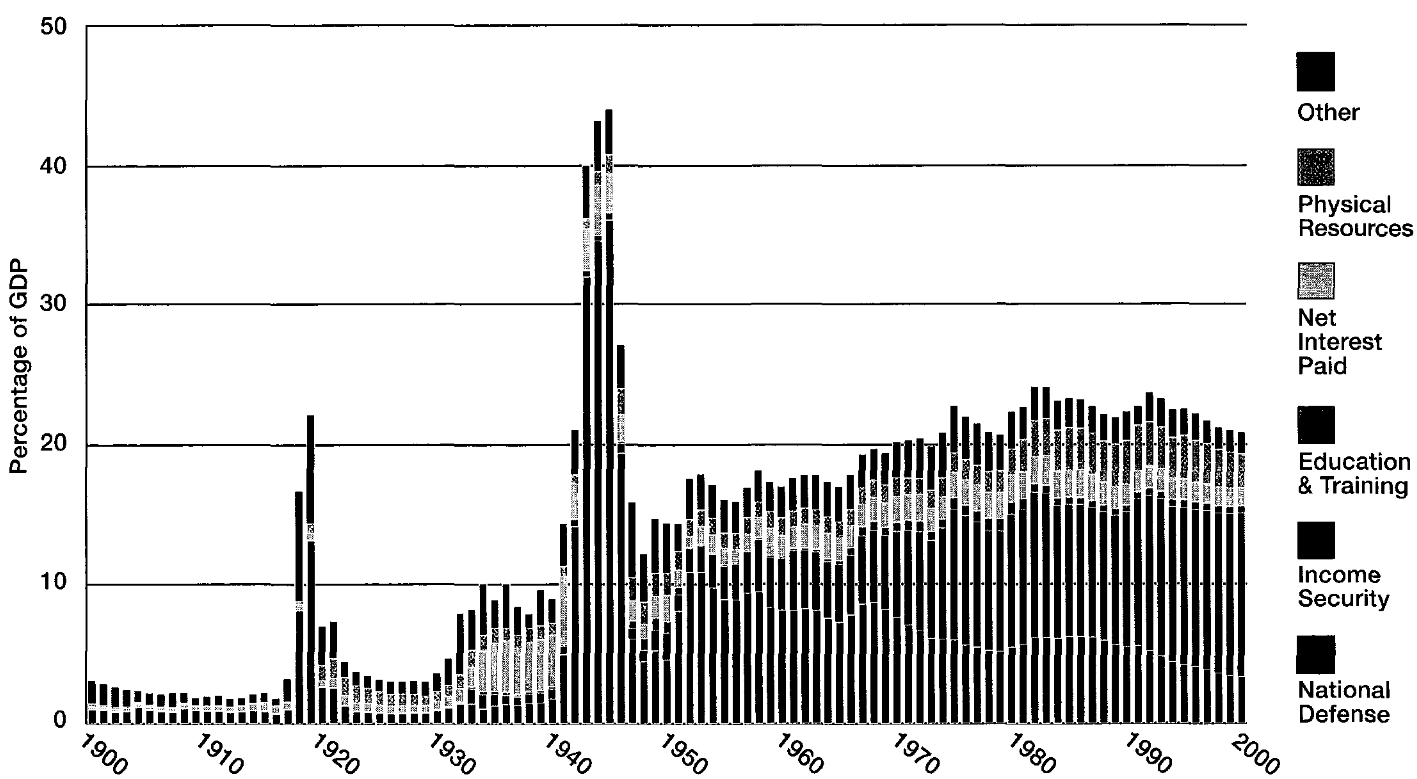
State and Local Government Expenditures

While state/local government spending has not grown as rapidly as federal expenditure, it has not sat still. Averaging 5.5 percent of GDP between 1900 and 1920, state/local spending concentrated on physical resources, education and training, and civilian safety. The 1920s saw a marked rise in state/local government spending. Expenditures averaged 7.3 percent of GDP as a result of higher spending in all three categories.

The Great Depression affected state and local government expenditures dramatically. Between 1930 and 1933,

Gov't Spending *continued on p. 6*

Figure 2
Federal Government Current Expenditures by Type As a Percentage of Gross Domestic Product
1900 – 2000



Source: Tax Foundation

Government Spending *from p. 5*

total spending soared from 8.3 percent of GDP to 13.3 percent. It dropped back down, but still averaged 10.4 percent of GDP over the decade.

The rebounding economy and the national emphasis on defense spending during the early 1940s helped push down the share of GDP dedicated to state and local government spending. After the war, however, state and local government expenditures climbed steadily as a percentage of GDP for the next 30 years. Between 1965 and 1975 it grew from 8.0 percent to 12.1 percent of GDP.

In 1998, income transfer programs are expected to account for 42.4 percent of government expenditures, a figure that was just 2.0 percent in 1900.

Most of this growth was attributable to spending on education and training, which hit 1.5 percent of GDP in 1945, 2.4 percent in 1955, 8.0 percent in 1965 and 12.0 percent in 1975. Spending on health and human services as well as civilian safety also increased during this period, while the amount spent on physical resources stayed relatively constant as a percentage of GDP, averaging 1.1 percent during this period.

State and local expenditures declined slightly as a percentage of GDP during the late 1970s and 1980s, but since 1989 levels of state and local government expenditure have once again risen sharply, surpassing the watershed levels of the mid-1970s. This is largely the result of increased spending on health and human services which is expected to equal 3.6 percent of GDP in 1998. Spending levels for civilian safety are also expected to be up while other categories stay flat.

The report is number 84 in the Special Report series and is available for $5 from the foundation.

Figure 3
Government Current Expenditures By Level of Government As a Percentage of Gross Domestic Product 1900 – 2000

	Current Expenditures				Current Expenditures		
	Total	Federal	State & Local		Total	Federal	State & Local
1900	8.16%	3.11%	5.09%	1950	20.37%	14.44%	5.79%
1901	7.50%	2.88%	4.65%	1951	19.11%	14.42%	5.46%
1902	7.48	2.67	4.73	1952	22.50	17.64	5.60
1903	7.49	2.47	4.93	1953	22.81	17.93	5.61
1904	7.93	2.38	5.40	1954	22.42	17.18	6.01
1905	7.63	2.18	5.35	1955	21.37	16.11	6.00
1906	7.09%	2.11%	5.10%	1956	21.37%	15.99%	6.15%
1907	7.36	2.23	5.16	1957	22.54	17.00	6.45
1908	8.09	2.21	6.06	1958	24.05	18.17	7.10
1909	7.29	1.84	5.33	1959	22.99	17.36	6.98
1910	7.18	1.94	5.35	1960	23.07	17.02	7.30
1911	7.65%	1.99%	5.57%	1961	24.01%	17.64%	7.70%
1912	7.22	1.79	5.34	1962	24.15	17.84	7.66
1913	7.18	1.83	5.29	1963	24.15	17.84	7.78
1914	8.42	2.11	6.42	1964	23.73	17.40	7.90
1915	9.14	2.15	7.15	1965	23.45	17.03	7.96
1916	8.18%	1.82%	6.70%	1966	24.22%	17.88%	8.16%
1917	9.36	3.27	5.97	1967	26.09	19.30	8.70
1918	21.90	16.72	5.21	1968	26.76	19.73	9.07
1919	27.34	22.17	5.19	1969	26.89	19.42	9.54
1920	12.10	6.99	5.17	1970	28.28	20.19	10.45
1921	14.66%	7.35%	7.37%	1971	28.72%	20.31%	10.99%
1922	11.44	4.48	7.11	1972	28.54	20.46	11.12
1923	10.31	3.72	6.69	1973	27.95	19.90	10.99
1924	10.60	3.46	7.24	1974	29.28	20.85	11.37
1925	10.06	3.16	7.05	1975	31.57	22.77	12.14
1926	10.18%	3.04%	7.21%	1976	30.63%	22.01%	11.98%
1927	10.51	3.03	7.65	1977	29.87	21.50	11.70
1928	10.49	3.07	7.61	1978	28.69	20.87	11.20
1929	10.02	3.01	7.17	1979	28.44	20.70	10.88
1930	11.75	3.64	8.30	1980	30.20	22.36	11.03
1931	14.40%	4.68%	10.05%	1981	30.64%	22.69%	10.76%
1932	20.82	7.95	13.25	1982	32.54	24.09	11.03
1933	20.46	8.18	13.30	1983	32.38	24.08	10.78
1934	19.58	10.08	10.90	1984	31.10	23.14	10.38
1935	17.78	8.89	10.14	1985	31.38	23.30	10.47
1936	18.18%	10.07%	9.14%	1986	31.56%	23.24%	10.76%
1937	16.45	8.42	8.93	1987	31.42	22.72	10.89
1938	17.23	7.88	10.19	1988	30.75	22.15	10.80
1939	18.50	9.62	9.79	1989	30.53	21.93	10.77
1940	17.19	8.95	9.12	1990	31.35	22.36	11.30
1941	17.05%	14.41%	7.27%	1991	32.11%	22.73%	11.97%
1942	26.18	21.06	5.69	1992	33.07	23.69	12.14
1943	44.07	40.02	4.55	1993	32.74	23.27	12.30
1944	46.79	43.23	4.03	1994	31.88	22.48	12.27
1945	48.07	44.04	4.46	1995	31.95	22.54	12.33
1946	31.67%	27.10%	4.95%	1996	31.66%	22.24%	12.28%
1947	21.22	15.91	5.12	1997	31.08	21.69	12.16
1948	18.13	12.22	5.21	1998	30.54	21.21	12.11
1949	21.51	14.74	5.81	1999	30.18	21.00	12.10
				2000	30.04	20.88	12.11

Source: Tax Foundation.

FOUNDATION MESSAGE

Roots of the Global Financial Crisis

Asian economies are contracting, and make no mistake — this is misery on a massive scale. After years of nearly zero growth, Japan's economy shrank in 1998. Combined with the troubles in Russia, this financial crisis is becoming truly global. So far, the United States has remained immune, but a slowdown is a sure bet and some economists are predicting a recession in 1999. This has created a worldwide urgency to "do something." Before our leaders act for the sake of action, let us take a moment to review the history.

The first spark in the conflagration occurred two summers ago in Thailand. Thailand had been growing strongly, like the other Asian tigers. Their real economic strengths were apparent and enticing. Yet hidden in the boom were rampant cronyism and graft. Even before the troubles began, Bangkok was littered with empty and half-finished skyscrapers, towering symbols of loans that should never have been made, projects that should never have been started, and all inflating the measures of economic growth.

Meanwhile, the Thai baht was partly tied to the U.S. dollar, and the persistently higher inflation rate in Thailand meant the baht was increasingly over-valued. Eventually, the baht would be devalued or Thailand's inflation would be brought below that of the United States. Facing these unpleasant options, the Thai government chose a third, to stall. Currency speculators know this game well and knew they would win. Overvalued currencies eventually devalue. The only question is when.

Periodically the speculators attacked the baht like an army probing its opponent for weakness to see if the government would defend the baht or let it fall. Two summers ago it fell. As it did, the price of the dollar-denominated loans that financed Thailand's graft-infested growth soared. Collapse and in many cases default were imminent and unavoidable.

It wasn't only Thailand that suffered. South Korea, Malaysia, and Indonesia faced similar fates. Nor was Thailand really the first. The core of Japan's economic troubles — over-regulation mixed with rampant cronyism — led it into similar straits at the start of the decade. The only difference was that the Japanese yen floated, so the problems were not masked by an over-valued currency.

J.D. Foster, Ph.D.
Executive Director &
Chief Economist
Tax Foundation

Thailand's fixed exchange rate system caused it to defend the indefensible — an overvalued baht. If the baht had floated, it would still have fallen — as it should when Thailand's inflation is relatively high — but the fall would have been gradual, not cataclysmic. The rapid fall of the baht was highly disruptive to commerce. Even worse, however, was the rapid rise in the cost of dollar-denominated borrowings.

The one certainty about exchange rates is that they will move. Under a flexible exchange rate system, they will move with broad swings, but sudden, destabilizing jumps are inevitable when governments fix an artificial price for their currencies. The fixed exchange rate system did not cause the recent trouble, but when governments intervened to sustain unsustainable exchange rates, they made matters worse. A true, floating baht would not have prevented Thailand's troubles, but it would have softened the blows, much as the floating yen cushioned Japan's troubles.

For that matter, the root cause of the trouble was not the international lending per se. It was the loans. In the United States and Europe, if a business borrows for capital expansion, a lender will generally analyze the borrower's financial strength and the economic prospects of the project. In much of the rest of the world, this sort of analysis cannot be meaningfully performed.

How exactly does one make a loan in an economy rife with graft and devoid of accurate financial accounting? Outside of the United States and Europe, few countries impose rigorous accounting standards. In this environment, lenders make loans knowing only that previous loan conditions were met, and hoping for future business. Human nature being what it is, such a system guarantees the repeated construction of entire cities of cards. Eventually, a hard enough tremor, like a currency devaluation, comes along to topple the cards.

An obvious partial solution for the future is for lenders to require borrowers to meet reasonable, audited financial accounting standards. Bad loans caused the global financial crisis that began in Poland in the early 1980s, spread to Mexico, and eventually enveloped most of the developing world as borrowers and most of the U.S. banking system as lenders. The lenders must bear their share of the responsibility, and the price.

A second partial solution is developing new regulations making lenders' exposures more transparent. This can go too far. But since this is the second financial crisis in the last twenty years, even free-marketers should hold their fire at least until the regulations are laid out.

These actions will make another financial crisis less likely, but the world is asking, "What do we do now?" Moving to a fixed or managed exchange rate system is clearly not the answer. Instead, individual countries must right their own ships. Japan, as the second largest economy in the world, bears a tremendous responsibility for not deregulating its economy and cutting taxes to encourage growth. Likewise, the United States must pursue monetary, tax, and regulatory policies to ensure that its economy remains strong. There may be no other solutions for the present. The root source of the trouble is bad loans. There are few good solutions when a loan is made, the debtor can't repay, and there is little collateral. The money is gone and nothing government can do will bring it back.

Chairman Bill Archer To Receive Distinguished Public Service Award

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The Tax Foundation will honor Chairman Bill Archer, Republican congressman of Houston, Texas, with its Distinguished Service Award for the Public Sector at its annual dinner November 19 at the Four Seasons Hotel.

As Chairman of the House Ways and Means Committee, Archer was a key architect of the Taxpayer Relief Act of 1997. In particular, the tax relief provisions included in the act had Archer's signature on them.

Long an advocate of promoting savings and investment by cutting the capital gains tax rates, Archer used this bill to achieve a major reduction. Overall, the Taxpayer Relief Act of 1997 not only helped to bring the budget into balance for the first time since 1969, but provided tax relief of some kind at every point on the income spectrum.

At passage, the Tax Foundation estimated the total reduction to be $95.3 billion over five years and $275.4 billion over ten years. Averaged out over the number of tax return filers, the relief amounts to $764 in savings per filer over five years, and $2,136 per filer over ten years.

Archer has served Texas's 7th district since 1971 when he won the seat previously held by former President George Bush, who remains one of his constituents. He became the ranking Republican on the Ways and Means Committee in 1988, and in that year first received the Tax Foundation's Distinguished Service Award.

He assumed the chairmanship of Ways and Means in 1994 and plans to relinquish it upon retirement from the Congress in 2000.

After so many years' service on the Ways and Means Committee, Chairman Archer well understands the destructive power of taxation and the disruptive power of the Internal Revenue Service on people's lives. Thus he has taken a lead role in championing fundamental tax reform, going so far as to say we must "tear the IRS out by its roots."

Congressman Bill Archer

His ambitious plans for the next Congress include fundamental tax reform. He believes replacing the income tax with a consumption tax would be fairer, simpler, and would unleash unprecedented economic growth.

The Ways and Means Committee also has jurisdiction over the Social Security system and Chairman Archer is well aware of the fiscal straits of Social Security. He has made it clear that the Ways and Means Committee must consider reforming this huge and critical program in the coming Congress.

Chairman Archer's service on the Ways and Means Committee has shown him to be a man of unwavering principle and a tireless defender of the American taxpayer. Widely respected on a bi-partisan basis for his vision, technical knowledge of the tax law, and his political acumen, Chairman Archer brings a common-sense approach to tax policy.

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