

updated for **2008**

Reality Check

Why It's Good to Be Rich – And Getting Better All the Time

A CENTURY FOUNDATION GUIDE TO THE ISSUES



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Why It's Good to Be Rich *And Getting Better All the Time*

*Uncle Sam Taxes Income from Wealth Much More
Lightly than Earnings from Work*

Under the new tax law enacted in 2002, capital gains and dividends are now taxed at a top rate of 15 percent. That is less than half the previous level. For middle-income taxpayers, earnings from employment are taxed more than twice as much—at income tax rates ranging from 15 percent to 28 percent,¹ plus the payroll tax of 15.30 percent (split evenly between workers and their employers).

Here is a simple example to illustrate what those differences mean:

Jill earns an annual salary of \$50,000 and has no significant deductible expenses. For 2007, she owed federal income taxes of \$6,736, plus Social Security and Medicare payroll taxes of \$3,825, for a total of \$10,561. Add the matching payroll tax of \$3,825 paid by her employer, and the total tax on her earnings comes to \$14,386.

Jack, a comfortable man of leisure, also collected \$50,000 in 2007, but that income arose entirely from long-term capital gains. His total tax bill: \$3,003. That is less than one-fourth of what the federal government collected on Jill's hard-earned salary.

1. "U.S. Federal Individual Income Tax Rates History, 1913–2008," Tax Foundation, January 2008, page 1, available online at <http://www.taxfoundation.org/taxdata/show/151.html>.

Why does the government prefer Jack's idle lifestyle to Jill's productive contribution to the nation's economy? Why did the tax changes enacted during the past several years substantially reduce the burden on Jack's portfolio while offering negligible relief to Jill? The administration and other proponents of the new tax laws offered these rationales:

- ◆ Just about everyone will benefit from cutting taxes on wealth because most people now own substantial investments.
- ◆ There is no way to reduce taxes sizably for low- and middle-income earners because their taxes are already paltry.
- ◆ Cutting taxes on wealth will boost the economy by increasing the incentive to save and invest, creating jobs in the process.

As the tables and charts that follow show, however, those claims are all wrong. In fact:

- ◆ The highest earners own the vast majority of stocks and bonds. Very few middle-income families benefit significantly from reduced taxes on wealth.
- ◆ Most low- and middle-income Americans pay a large share of their earnings to the federal government mainly in the form of payroll taxes. They also pay more than their fair share of state and local taxes.
- ◆ There is no evidence that past reductions in taxes on investments have increased national savings or otherwise have strengthened the economy.

Only a Small Minority of Nonwealthy Families Own Stocks, Bonds, and Mutual Fund Shares outside of Retirement Savings Accounts

Media reports have frequently touted the emergence of a new “investor class” purportedly comprising larger numbers of middle-income families. One widely quoted figure in support of that claim is that 51.9 percent of families held stock in some form (either directly or indirectly through mutual funds) in 2001, a level three percentage points above that in 1998.

But that does not mean that more than half the country benefits from reductions in taxes on income from investments. A large portion of middle-income families who own stocks and mutual fund shares keep them primarily or exclusively in tax-deferred retirement savings accounts such as IRAs and 401(k)s, which already are shielded from current income taxes. Reducing current income taxes on capital gains and dividends has no impact on investors who keep all of their holdings in tax-deferred accounts.

Leaving aside investments held in tax-deferred retirement savings accounts, Federal Reserve survey data from 2004 show that *only 21 percent of all American families own stocks, 2 percent hold bonds, and 15 percent invest in mutual funds.*² Moreover, those who own such investments outside of tax-deferred accounts are concentrated heavily among the families with the highest incomes.

2. Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, “Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,” *Federal Reserve Bulletin*, 2006, p. 13, available online at <http://www.federalreserve.gov/Pubs/Bulletin/2006/financesurvey.pdf>.

Table 1. Percentage of Families Holding Particular Assets

Income Percentile	Stocks	Bonds	Mutual Funds
Under 20	5.1%	—	—
20–39.9	8.2%	—	7.6%
40–59.9	16.3%	—	12.7%
60–79.9	28.2%	2.2%	18.6%
80–89.9	35.8%	2.8%	26.2%
90–100	55.0%	8.8%	39.1%

Source: Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, “Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,” *Federal Reserve Bulletin*, 2006, p. 13, available online at <http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf>.

Table 1 categorizes American families according to their income percentiles (those from the bottom to the twentieth percentile are in the lowest fifth of the income distribution; those from the ninetieth to the one-hundredth percentile are in the top tenth). For each income grouping, the table reports the share of families who own a particular type of asset outside of retirement accounts.

Note that the only investment held by a majority of the families in any income grouping is the stocks owned by those in the top tenth of the income distribution. What is more, the benefits of tax cuts depend not only on *if* a household owns an asset but also on *how much* it owns. It turns out that almost all dividends go to top earners.

The Wealthiest Taxpayers Collect the Vast Majority of Dividends and Capital Gains

The average amounts of taxable dividend and capital gain income collected by individual taxpayers at different levels of annual adjusted gross income is another indicator of inequality (see Table 2).

Table 2. Average Taxable Dividend and Capital Gain Income Collected by Individual Taxpayers, 2006

	Annual Adjusted Gross Income					
	Under \$15,000	\$15,000– \$30,000	\$30,000– \$50,000	\$50,000– \$100,000	\$100,000– \$200,000	Over \$200,000
Dividends	\$169	\$226	\$370	\$921	\$2,693	\$25,304
Capital Gains	\$276	\$192	\$384	\$1,250	\$5,365	\$134,205

Source: "Individual Income Tax Returns, Preliminary Data, 2006," Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2008, p. 13, available online at <http://www.irs.gov/pub/irs-soi/06inplim.pdf>.

If anything, these averages overstate the extent to which middle-income taxpayers benefit from earnings on investments held outside of tax-deferred retirement savings accounts because most of those individuals do not collect a dime of dividends or capital gains (see Table 3).

Table 3. Percentage of Taxpayers Who Reported No Taxable Dividend or Net Capital Gain Income from Investments, 2006

	Annual Adjusted Gross Income					
	Under \$15,000	\$15,000– \$30,000	\$30,000– \$50,000	\$50,000– \$100,000	\$100,000– \$200,000	Over \$200,000
Dividends	88%	88%	83%	68%	46%	21%
Capital Gains	96%	96%	93%	87%	75%	50%

Source: "Individual Income Tax Returns, Preliminary Data, 2006," Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2008, p. 13, available online at <http://www.irs.gov/pub/irs-soi/06inplim.pdf>.

*Most Households—71 Percent—Pay More
in Payroll Taxes than in Income Taxes*

The federal income tax system is "progressive" in that it levies a greater share of the nation's taxes on households with higher incomes. But the payroll tax system that finances Social Security and part of Medicare is regressive: the richest Americans pay a smaller share of their earnings in payroll taxes than do low- and middle-income workers.

In 2008, the payroll tax, which applies only to income from work (not investments), amounts to a flat 7.65 percent on a worker's earnings up to a cap of \$102,000, plus a matching 7.65 percent paid by employers on the same earnings. Because only the Medicare portion of the payroll tax is levied on incomes above the \$102,000 threshold, upper-income workers owe a lesser share of their total earnings. And because the payroll tax excludes interest and dividend income—which, we have just seen, goes mostly to top earners—it applies most heavily to low- and middle-income households.

Table 4 summarizes the “effective” tax rates collected from the different kinds of federal taxes on people at different earnings levels. The effective rate is the tax a family owes as a share of its income from all sources, including nontaxable items like employer-paid health insurance premiums and food stamps.

Table 4. Effective Federal Tax Rates, 2005

Income Percentile	Income Tax	Payroll Tax	Excise Tax	Corporate Income Tax	Total Tax Rate
Under 20	-6.5%	8.3%	2.1%	0.4%	4.3%
20–39.9	-1.0%	9.2%	1.3%	0.5%	9.9%
40–59.9	3.0%	9.5%	1.0%	0.7%	14.2%
60–79.9	6.0%	9.7%	0.8%	1.0%	17.4%
80–100	14.1%	6.0%	0.5%	4.9%	25.5%

Source: “Historical Effective Federal Tax Rates: 1979 to 2005,” Congressional Budget Office, December 2007, p. 6, available online at <http://www.cbo.gov/ftpdocs/88xx/doc8885/12-11-HistoricalTaxRates.pdf>.

One of the reasons why so few low- and middle-income families noticed any significant improvement in their finances in the wake of recent income tax law changes is that most of the taxes they owe take the form of regressive payroll rather than progressive income taxes (see Table 5).

Table 5. Percentage of Households Whose Payroll Taxes Exceed Their Income Taxes, 2001

Income Percentile	Percentage
0–20	99.3%
20–40	96.8%
40–60	90.9%
60–80	80.8%
80–100	29.3%

Note: Data are for households that were subject to payroll taxes in 2001. They include both the employee and employer share of payroll taxes because most economists have concluded that workers bear the entire cost of such taxes in the form of lower compensation than they would otherwise receive.

Source: Congressional Budget Office, “Effective Federal Tax Rates: 1997–2000,” August 2003, pp. 72–73, available at <http://www.cbo.gov/showdoc.cfm?index=4514&sequence=1>.

Because payroll taxes finance Social Security and part of Medicare, it might seem as though there would be no plausible way to offset their effects on family budgets without cutting into those two vital programs. But a number of possibilities exist, such as a refundable income tax credit equal to a portion of the payroll taxes that families owe. Even low-income taxpayers who do not pay income taxes at all would still receive a rebate, much as they now do through the earned income tax credit. Moreover, the change would encourage low-income individuals to work more, since they would be collecting a higher share of their earnings. Other possibilities include refundable income tax credits that could be created for child care and other costs, which would benefit primarily low- and middle-income individuals.

*There Is No Evidence that
Cutting Taxes on Investment Income
Generates Lasting Economic Gains*

Advocates of cutting taxes on investment income often claim that the policy will encourage higher levels of saving and investment, thereby promoting long-term economic growth. There is no persuasive evidence to support that claim. Federal tax rates on capital gains income have been raised and lowered a number of times in the past, with little long-term effect.

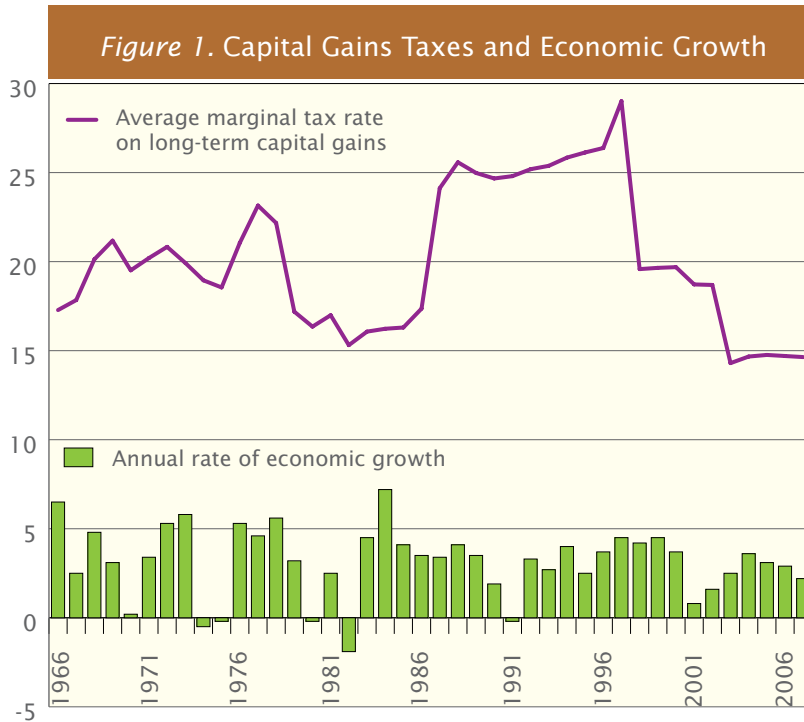


Figure 1 shows, for example, that the nation's economic growth was higher when the capital gains rate reached a peak of 23 percent during the 1976–79 period than after it was reduced to 17 percent. There simply is no concrete basis to support assertions about the broad economic benefits of reducing investment taxes. GDP has varied widely over the past forty years, even when the tax rate has been relatively stable (1966–75, 1979–86, and 1988–96). The long-term path of the economy is influenced by many powerful forces that overwhelm a relatively minor consideration such as the tax rate on investment income.

Source: Daniel Feenberg and Elizabeth Coutts, "An Introduction to TAXSIM Model," *Journal of Policy Analysis and Management* 12, no. 1 (Winter 1993): 189–94; "US Federal Average Marginal Income Tax Rates," National Bureau of Economic Research, August 2007, available online at <http://www.nber.org/~taxsim/marginal-tax-rates/federal.html>; "National Income and Product Accounts Table," Bureau of Economic Analysis, April 2008 available at <http://www.bea.gov/national/nipaweb/SelectTable.asp?Popular=Y>.

A Fairer Plan: Treat All Income Equally

Even if capital gains and dividends were to be taxed at the same rates as earnings from work, investment earnings would still face a lighter levy. That is because:

- ◆ capital gains and dividends remain exempt from the payroll tax;
- ◆ capital gains can continue to be shielded from current taxation through IRAs, 401(k)s, and other tax-deferred savings plans; and
- ◆ capital gains outside of retirement accounts are taxed only when they are realized through the sale of an investment—appreciation of an asset enhances the owner's wealth without generating a current tax liability, while earned income is subject to immediate taxation.

By greatly reducing taxes on wealth beyond those established breaks, the recent tax law significantly benefited only a small number of high-income Americans, in ways that are unlikely to do the rest of the country any good. At a minimum, income on investments held outside of retirement accounts should be taxed at the same levels as earnings from work.

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