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THE FACTS SUPPORT RAISING REVENUES FROM THE HIGHEST-INCOME HOUSEHOLDS

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The nation's debt ceiling has just been raised in concert with deficit-reduction legislation that initially relies solely on nearly $1 trillion in cuts to discretionary spending over 10 years. A second phase of the legislation will likely force spending cuts of another $1.2 trillion to $1.5 trillion by 2021.

A preoccupation with deficit reduction in the short term is misguided, and the legislation's focus is further skewed by its one-dimensional approach to the nation's budget problems. Policymakers should focus on reducing the long-term deficit with strategies that mirror past efforts and rely on both revenue increases and spending reductions, instead of merely spending cuts.

It is an especially apt time to raise revenues from the highest-income Americans as part of deficit-reduction efforts. This analysis focuses on taxing the small fraction of households who would see their tax burdens increase under the president's budget request, those with adjusted gross income exceeding $200,000 ($250,000 for joint filers).[1] Households above these AGI levels constituted 2.8% of tax filers in 2009. The tax proposals discussed largely affect the top 1% of households, which can and should contribute the most to deficit reductions. The following 10 facts support increasing what the highest-income households contribute in taxes:

1. Meager revenues and Bush-era tax cuts contribute greatly to the deficit.

2. The top one percent of households benefited disproportionately from the Bush-era tax cuts.

3. Recent income gains for the highest-income one percent have far exceeded gains for everyone else, leading to dramatic income concentration at the top of the scale. Now, more than ever, the highest-income households are in a better position to pay taxes.

4. Wealth is even more concentrated at the top than income, and the main wealth tax—the estate tax—has been sharply reduced in recent years.

5. Reasonable proposals for taxing the highest-income households can raise significant amounts of revenue.
6. By not taxing the highest-income households, deficit reduction relies too heavily on spending cuts that harm low- and middle-income Americans.
7. Raising taxes on the highest-income households reduces the deficit without having much impact on the economic recovery or job growth.
8. Few small business owners have exceptionally high incomes, and thus few would be affected by these tax increases on the highest-income households.
9. Even if taxes on those with the highest incomes are substantially increased, income gains at the top over time would still dramatically outpace gains among the rest of the population.
10. The progressivity of the federal income-tax system offsets the regressive nature of federal payroll taxes and state and local tax systems.

All of these 10 facts are elaborated upon below.

1 Meager revenues and Bush-era tax cuts contribute greatly to the deficit.

In 2010, federal revenues were equivalent to 14.9% of gross domestic product, with a similar or perhaps even lower share expected this year, according to the Congressional Budget Office.[2] In fact, federal revenues amounted to the smallest share of the economy since 1950,[3] before programs such as Medicare or Medicaid even existed. Low revenue levels, resulting both from a weak economy and a decade's worth of deliberate tax policies, contribute to the large size of the federal deficit, and raising revenue should be part of any deficit-reduction package.

The Center on Budget and Policy Priorities estimates that the Bush-era tax cuts, if continued, will together be the single largest contributor to the deficit between 2009 and 2019.[4] The Bush-era tax cuts will account for $5.4 trillion (43%) of the cumulative deficit over this period. This is more than three times the combined effect of all the policies enacted in response to the Great Recession, including the policies to assist the financial system adopted in the fall of 2008 (TARP), the large stimulus bill adopted in February 2009 (ARRA), and other policies (tax cuts, state fiscal relief, and unemployment insurance) subsequently adopted or extended.

The Bush-era tax cuts not only depleted revenue but also increased spending because they were deficit-financed, thus adding to the public debt and net interest. Last decade's worth of Bush-era tax cuts are adding roughly $50 billion in interest spending to this year's deficit alone.[5]

2 The top one percent of households benefited disproportionately from the Bush-era tax cuts.

According to the Tax Policy Center,[6] in 2010 incomes of the one percent of households with the most income (i.e., tax filers making more than $620,000 in 2008 dollars) jumped by 7.3% due to the tax cuts enacted from 2001-08. This increase was more than that of any other group, and nearly three times the percentage gain of the middle fifth of filers. In dollar terms, the top one percent garnered an average of $97,000 from these Bush-era tax cuts in 2010, or 90 times the average tax cut of $1,079 received by the middle fifth of filers. The top one percent received 38% of the total amount of these tax cuts, which is more than the combined amount of the total amount of the tax cuts received by the bottom 80% of tax filers.

3 Recent income gains for the highest-income one percent have far exceeded gains for everyone else, leading to dramatic income concentration at the top of the scale. Now, more than ever, the highest-income households are in a better position to pay taxes.

According to the latest data from the Congressional Budget Office, the average after-tax income of the one percent of highest-income households nearly quadrupled in less than three decades, jumping from $347,000 in 1979 to $1,320,000 in 2007. (All figures are adjusted for inflation and expressed in 2007 dollars.[7]) This average increase of 4.9% per year dwarfs the historically meager average gain of 0.8% per year among the middle fifth of households. If overall income growth between 1979 and 2007 had been the same but occurred at the same pace among all groups, the average after-tax income of the middle fifth of households would have been $13,000 higher in 2007,[8] and the percentage gain would have been more than double what it was.

This disparity in income gains led to a dramatic shift in the distribution of national income. In 2007, the one percent of households with the highest incomes received 17.1% of all after-tax income, more than double their 7.5% share in 1979. In 1979, the share of national after-tax income going to the top one percent of households was far *smaller* than the share of after-tax income received by the middle fifth of households (7.5% versus 16.5%). But by 2007, income distribution had been radically changed: The top one percent of households had a *larger* share of national income than the middle fifth of households (17.1% versus 14.1%).

If overall after-tax income growth between 1979 and 2007 had been the same but occurred at the same pace among all groups, the highest-income one percent of households combined would have had $860 billion less in national after-tax income in 2007 (in this scenario, their average after-tax incomes still would have equaled $537,000 in 2007, up from an average of $347,000 in 1979). Meanwhile, the bottom 90% of households combined would have had $990 billion more.

Note that incomes at the top have generally risen and fallen in line with the economic cycle; in other words, decreases in tax rates were not what drove income growth. In fact, the 10-year period in which before-tax incomes of the top one percent grew the most (nearly doubling) was from 1990 to 2000, when the average federal tax rate for this group actually *rose* from 28.8% to 33.0%.

4 Wealth is even more concentrated at the top than income, and the main wealth tax—the estate tax—has been sharply reduced in recent years.

A recent Economic Policy Institute report on wealth trends[9] found that while about one-fifth of national income goes to the highest-income one percent of households, more than one-third of national wealth is held by the wealthiest one percent of households. The middle 20% of households held just 4% of national wealth in 2007, and their share strank even more during the Great Recession.

In 2009, the last year examined by the report, the wealthiest one percent of households "had net worth that was 225 times greater than the median or typical household's net worth in 2009. This is the highest ratio on record."

Despite this concentration of wealth at the top, federal tax policy over the last decade has greatly reduced (and briefly eliminated) the only federal tax on concentrated wealth: the estate tax, which is the most progressive federal tax. The Bush-era tax cuts raised the estate tax exemption from $675,000 (single filer) in 2001 to $3.5 million (single filer) in 2009, and at the same time lowered the top tax rate from 60% to 45%. The estate tax was then fully repealed for 2010 and later reinstated for 2011 at a record high exemption of $5 million (single filer) and a historically low rate of 35%. This weakened estate tax ends up applying to only the top quarter of one percent (0.25%) of all estates in the country.[10]

5 Reasonable proposals for taxing the highest-income households can raise significant amounts of revenue.

Because so much income and wealth have accrued to those at the top in recent decades, and because taxes at the top have been significantly reduced, relatively modest tax proposals affecting these individuals can generate considerable revenue.

The president's 2012 budget proposed repealing the Bush-era tax cuts for individuals with adjusted gross income exceeding $200,000 ($250,000 for joint filers), a proposal that would increase tax liability for only 1.9% of the population, relative to current tax policies.[11] This policy would raise $709 billion in revenue over a decade, and reduce the deficit by roughly $838 billion (accounting for reduced interest payments), without raising taxes on 98% of Americans.[12]

Adding an additional tax bracket for individuals at the very highest income levels would also raise considerable revenue. A millionaire surcharge establishing a top tax rate of 45% (still below the top tax rate from 1932 to 1986)[13] was proposed in an early version of the 2010 health care reform bill, and would have raised $544 billion over a decade.[14] In the enacted version, the proposal was replaced with a more modest surcharge on investment and earned income that will raise $210 billion over a decade.[15]

Many tax expenditures give a larger benefit to upper-income earners because the value of the benefit is determined by a filer's marginal bracket.[16] Rather than eliminating individual tax expenditures, the president's 2012 budget also proposed limiting the benefit on itemized deductions to 28% for upper-income tax filers. This proposal would generate $293 billion in revenue over a decade, while reducing the regressive nature of itemized deductions and leaving in place incentives for middle-class families.[17] If the benefit on itemized deductions were limited to 15% (the rate that applies to most of the middle class) $1.2 trillion could be raised over a decade while still leaving incentives intact.[18]

Some tax expenditures affect income sources concentrated among those with the highest incomes. Repealing the preferential treatment of capital gains, which are taxed at much lower rates than income earned through work, would be another way to raise significant revenue while leaving most tax filers unaffected. More than 83% of the tax change would fall on the top 1% of households by income, and 92% of Americans would see no increase in their taxes.[19] Taxing capital gains as ordinary income up to a top rate of 28%, as was done by President Reagan as part of the Tax Reform Act of 1986, would generate $168 billion over a decade relative to current law.[20]

The estate tax, as previously noted, is a particularly progressive tax. Returning the estate tax back to its parameters in 2009, as the president's 2012 budget proposed, would increase revenues by $98 billion over a decade, relative to current policy.[21] A proposal by Senator Bernie Sanders (I-Vt.) that would maintain the 2009 exemption levels ($3.5 million for a single filer and $7 million for a couple) but institute a graduated rate structure above that level, would raise an additional $73 billion over a decade (relative to the president's 2012 budget).[22]

For a more comprehensive set of tax policies and reforms to restore revenue adequacy, see *Investing in America's Economy: A Budget Blueprint for Economic Recovery and Fiscal Responsibility*, a progressive long-term approach to strengthening the economy, rebuilding the American middle class, and stabilizing debt as a share of the economy.[23]

6 By not taxing the highest-income households, deficit reduction relies too heavily on spending cuts that harm low- and middle-income Americans.

Historically, deficit-reduction efforts have included a combination of tax increases and spending cuts. Reflecting this history, recent bipartisan recommendations to address the deficit have also included both elements.

This balanced approach of combining targeted spending cuts and revenue increases reflects the understanding that, otherwise, deficit reduction requires spending cuts that are overwhelmingly borne by low- and middle-income Americans. Domestic government spending tends to fall into two categories: public goods and public investments that benefit all citizens (e.g., highway investments, basic scientific research, food safety inspections, and law enforcement) and social insurance programs (e.g., Social Security, Medicare, Medicaid, unemployment insurance, and food assistance). All citizens lose if spending on public goods and investments are cut. And low- and middle-income Americans lose considerably more from cuts to social insurance programs, because transfer payments from programs such as Social Security have a larger relative impact on disposable income for lower-income workers, and because programs such as Medicaid and food assistance are means tested.

Unfortunately, the debt ceiling deal adopted a spending cuts-only approach. Over the next decade, a first round of cuts will decrease discretionary spending by almost $1 trillion; the non-security discretionary budget, which houses nearly 90% of nondefense public investment,[24] will bear the overwhelming brunt of these cuts. In a second phase, a bipartisan committee is required to negotiate an additional $1.2 trillion to $1.5 trillion in savings, but conservatives have vowed that revenue will not be part of the package. If there is no bipartisan agreement, as seems quite possible, it would trigger another $1.2 trillion of budget cuts, half of which would come from nondefense spending.[25]

While the debt ceiling deal poses a grave risk to public goods and investments in the discretionary budget, the House Republican 2012 budget concretely demonstrates the threat of imbalanced budgeting with respect to mandatory spending, particularly social insurance and low-income economic security programs. Over the next decade, the House Republican budget assumes revenue averaging 17.7% of GDP,[26] roughly the same as set by current tax policies.[27] At the same time, the budget proposed ending guaranteed Medicare and replacing it with a voucher; halving federal spending on Medicaid over two decades [28]; and deeply cutting food stamps, Pell Grants, and non-security discretionary spending. Relative to the president's 2012 budget request, the Ryan budget proposed cutting spending by $6.2 trillion over 10 years—including $2.5 trillion from health care spending alone. The Center on Budget and Policy Priorities estimates that roughly two-thirds of the budget cuts in the House Republican budget would come from programs for lower-income Americans.[29]

7 Raising taxes on the highest-income households reduces the deficit without having much impact on the economic recovery or job growth.

Both economic theory and the recent experience with the Bush and Clinton-era tax changes suggest that raising taxes on those with the highest incomes will have little impact on economic growth.

The economics literature, private-sector forecasters, and the Congressional Budget Office concur that raising taxes on the wealthy has relatively little effect on near-term economic activity compared with other options for reducing the deficit, namely raising taxes on lower-income earners or cutting government investment, safety net spending, or transfer payments. Mark Zandi, chief economist at Moody's Analytics, recently estimated that permanently extending the Bush income-tax cuts would generate only 35 cents in economic activity for every dollar in revenue lost; by contrast, the Earned Income Tax Credit generates $1.24 in economic activity per dollar of tax cut, or more than three times the bang for the buck. (Economic theory suggests that

the fiscal multiplier for just the upper-income tax cuts is considerably lower than the multiplier for extending all the Bush income-tax cuts, which included higher bang-per-buck provisions such as an expansion of the EITC and Child Tax Credit.) Similarly, infrastructure spending generates $1.44 in economic activity per dollar spent, and unemployment benefits generate $1.55 per dollar spent.[30]

These results hold with economic theory: Higher-income individuals are more likely to save an extra dollar of disposable income than low- or middle-income tax filers and, conversely, a dollar less of disposable income will displace less consumption by the wealthy. This means that if taxes on high-income households are increased by a dollar instead of reducing domestic spending on, say, infrastructure, by a dollar, the net effect on the economy and employment would be strongly positive, another argument against a spending cuts-only approach to deficit reduction. Indeed, the multipliers suggest that raising four dollars in upper-income tax revenue while increasing infrastructure investment by a dollar would generate positive economic growth, while also reducing the deficit by more than three dollars.

The objectively dismal performance of the Bush economic expansion, especially relative to the Clinton economic expansion, serves as a concrete illustration of the effects of tax cuts on the highest-income households. With tax cuts representing the core of Bush's economic policy, the recovery from 2001 through 2007 was the worst-performing economic expansion of the post-World War II era, whether measured by investment, GDP, employment, or wage growth.[31] The upper-income tax cuts were supposed to trickle down to middle-class paychecks, but never did; instead, inflation-adjusted median weekly earnings fell by 2.3% despite a 15.4% increase in nonfarm worker productivity.[32]

Taxes on high incomes were raised significantly during the Clinton years, but the number of jobs rose substantially. The Bush economic expansion witnessed an average of 97,000 jobs created every month—not enough to keep up with population growth—compared with 237,000 per month under the Clinton expansion (which also lasted longer). The Clinton economy was indisputably robust, and raising taxes helped lead to four consecutive years of budget surpluses—the only such instance since the Great Depression—and debt as a share of the economy fell from 49% of GDP in 1993 to 32% of GDP in 2001.[33]

8 Few small business owners have exceptionally high incomes, and thus few would be affected by these tax increases on the highest-income households.

Opposition to restoring Clinton-era tax rates on the top 2% of earners is often predicated on the supposed interests of small businesses. But the overwhelming majority of tax filers with small business income earn considerably less than $200,000 ($250,000 for joint filers), the adjusted gross income thresholds above which the top two rates would rise. According to the Tax Policy Center, only 3% of the 20 million individuals who report business income fall into the top two marginal tax brackets.[34] And business income per se accounts for only a modest fraction (between 16% and 28%) of total earnings for those tax filers with any small business income and earnings over these thresholds.[35]

The small businesses that would be adversely affected by an increase in the top two marginal tax rates are typically not mom and pop grocery stories, but are often "pass-through" businesses such as S corporations, partnerships, sole proprietorships, or limited liability companies, which make up a small amount of filers but a large fraction of small business income. These self-incorporated individuals (think owners of hedge funds and law and real-estate partnerships) account for between one-third and one-half of business income reported on individual tax returns.[36] Even if their top marginal tax rate were restored from 35% to 39.6%, pass-through companies would still face a lower tax rate than if their owners reorganized the business as a C corporation.[37]

9 Even if taxes on those with the highest incomes are substantially increased, income gains at the top over time would still dramatically outpace gains among the rest of the population.

The president's 2012 budget included significant tax increases affecting those at the top of the income spectrum, raising $1.1 trillion over the next decade relative to current tax policy.[38] According to data from the Tax Policy Center,[39] nearly nine in 10 dollars raised by those proposals would come from the highest-income one percent of taxpayers; their average federal tax rate would increase 3.9 percentage points to 34.4%. This is equivalent to their average tax rate during the Clinton administration, a period in which they fared quite well; the average after-tax income of the highest-income one percent of households rose by 78 percent, or $455,000 per household, in the Clinton era.[40]

If the average tax rate of the top one percent in 2007 had been 3.9 percentage points higher that year than it actually was, their average after-tax income would still have risen by $900,000, or by 260%, between 1979 and 2007, still dwarfing the modest gains during this period by the middle class ($11,200, or 25%). Indeed, even if their taxes had been 3.9 percentage points higher, the average after-tax income of the highest-income one percent of households would still have equaled $1.25 million.[41]

10 The progressivity of the federal income-tax system offsets the regressive nature of federal payroll taxes and state and local tax systems.

The progressive federal income tax system is layered on top of much more regressive tax systems: federal payroll taxes and the state and local tax system. Payroll taxes are generally flat, meaning that all workers pay the same rate, and in the case of Social Security contributions, they are only applied to a certain level of work income (up to $106,800 in 2011). Consequently, lower-income workers pay a much higher effective payroll tax rate. State and local governments generate a considerable share of their revenue from consumption taxes, which are also more regressive than the federal income-tax system.

According to the latest data from the Congressional Budget Office,[42] the average effective payroll tax rate for those with incomes in the top one percent was just 1.6% in 2007. This compares with a 9.4% effective tax rate for the middle fifth of Americans. Because of widening income inequality, more income has escaped the Social Security ceiling on taxable earnings: In 2009, only 83% of economy-wide earnings were covered by the Social Security payroll tax, down from 91% in 1983.[43] Unsurprisingly, effective payroll tax rates have trended downward for the top one percent of earners, falling one percentage point since 1994, but have remained largely stable for the middle fifth of Americans over this period (falling only one-tenth of a percentage point).

Citizens for Tax Justice finds that the highest-income one percent of Americans pay 7.9% of their income in state and local taxes, or less than any other group examined. The middle fifth of Americans pay a much higher 11.2% of their income in state and local taxes.[44]

Endnotes

1. Adjusted gross income (AGI) is gross income, which includes wages and other forms of income such as capital gains, dividends, interest, and rent, adjusted for above-the-line deductions such as IRA and health savings account contributions. The president's 2012 budget proposes restoring the top two marginal tax rates to 36% and 39.6% for single filers with AGI above $200,000 ($250,000 for joint filers). The personal exemption phase-out (PEP) and limitation on itemized deductions (Pease) would also be reinstated for these filers and the preferential rate on qualified dividends and long-term capital gains would rise from 15% to 20% (dividends are scheduled to be taxed as ordinary income starting in 2013). The political debate over revenue has largely focused on these top 2.8% of earners, but the Bush-era tax cuts will continue to jeopardize public investments and economic security programs if only these tax cuts are allowed to expire. For AGI distribution, see Internal Revenue Service (IRS). 2011. "Table 1.1 Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2009." Internal Revenue Service, Statistics of Income Tax Stats – Individual Income Tax Returns, Statistical Tables. http://www.irs.gov/pub/irs-soi/09in11si.xls.
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16. For instance, the home-mortgage interest deduction—homeowners can deduct interest payments on up to $1 million in mortgage debt and up to an additional $100,000 in home equity loans—is worth 35 cents on the dollar to joint filers with taxable income of $500,000, 15 cents on the dollar for itemizing joint filers with $50,000 in taxable income, and nothing for the 64% of filers taking the standard deduction. Consequently, two-thirds of the benefit of the home-mortgage interest deduction goes to tax filers in the top earnings quintile (with cash income above $122,764). See Tax Policy Center (TPC). 2011. "T11-0009 - Repeal the Mortgage Interest Deduction Against Current Policy." Tax Policy Center's The Numbers web page, February 24. http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2888. Tax Policy Center distributional analysis is measured in terms of tax units filing together in 2015, relative to current tax policy.

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20. This estimate is based on the Urban-Brookings Tax Policy Center's analysis of *Investing in America's Economy: A Budget Blueprint for Economic Recovery and Fiscal Responsibility*, as adapted and independently scored for the Solutions Initiative and funded by the Peter G. Peterson Foundation. The Peterson Foundation convened organizations with a variety of perspectives to develop plans addressing our nation's fiscal challenges. The American Enterprise Institute, Bipartisan Policy Center, Center for American Progress, Economic Policy Institute, The Heritage Foundation, and Roosevelt Institute Campus Network each received grants. All organizations had discretion and the independence to develop their own goals and propose comprehensive solutions. The Peterson Foundation's involvement with this project does not represent endorsement of any plan. The final plans developed by all six organizations were presented as part of the Peterson Foundation's second annual Fiscal Summit in May 2011. The TPC estimate of the capital gains provisions in the EPI plan was scored against a baseline that assumes the 2001 and 2003 tax cuts expire, but the AMT patch is extended permanently and indexed to the consumer price index.
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22. Under this proposal, the taxable portion of estates beyond the exemption levels would be subject to a 45% marginal tax rate between $3.5 million and $10 million; a 50% marginal tax rate between $10 million and $50 million; a 55% marginal tax rate between $50 million and $500 million; and a 65% marginal tax rate on the portion of estates worth over $500 million. See Fieldhouse, Andrew. 2011. "The People's Budget: A technical analysis." Washington, D.C.: Economic Policy Institute, Working Paper 290. http://www.epi.org/page/-/WP290_FINAL.pdf?nocdn=1
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