
Topics Related to the President's Tax Relief



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The President’s tax relief, enacted principally in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, the Working Families Tax Relief Act of 2004, the American Jobs Creation Act of 2004, the Tax Increase Prevention and Reconciliation Act of 2005, and the Economic Stimulus Act of 2008, reduced taxes for everyone who pays income taxes. This document provides discussions and estimates on several topics related to the President’s tax relief.

Topics

Recent Trends in Federal Tax Receipts as a Percentage of GDP.....	1
Who Pays Most Individual Income Taxes?.....	2
Income Mobility	3
How Has the President’s Tax Relief Reduced the Marriage Penalty?	5
Effect of Lowering the Top Individual Tax Rates on Flow-through Businesses.....	6
Encouraging Investment.....	7
How Might Taxpayers Respond to Higher Tax Rates?.....	8

Recent Trends in Federal Tax Receipts as a Percentage of GDP

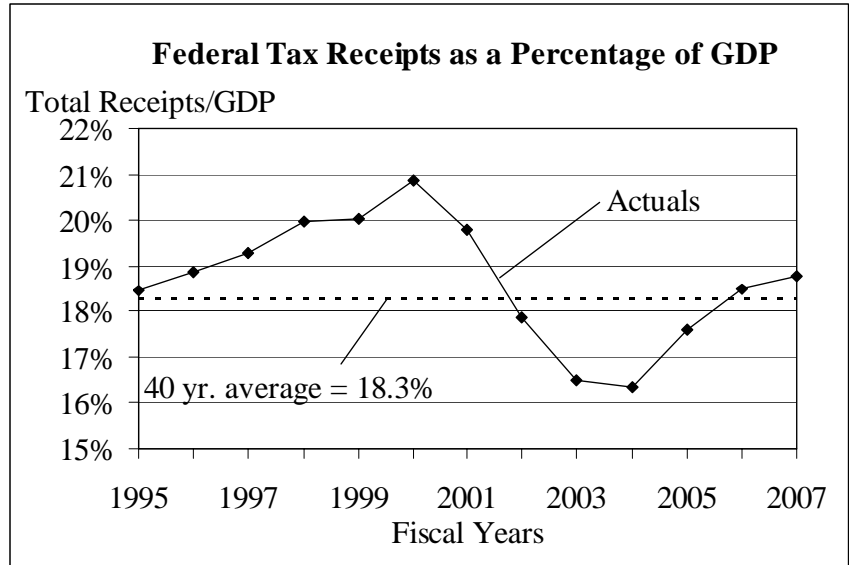
Over the past 40 years, the ratio of total federal receipts to GDP has been relatively stable, averaging 18.3 percent. Recently there have been significant swings in the share: receipts first rose dramatically to a post-war high of 20.9 percent of GDP in 2000, then fell precipitously as the economy slowed to a low of 16.3 percent in 2004, before rising again to a tax-to-GDP ratio of 18.8 percent in 2007.

Growth in Receipts: 1995 - 2000

Much of the growth during the late 1990s can be attributed to the extraordinary performance of the stock market and its effects on individual income tax receipts.

Capital gains income, which is not captured in GDP, more than quadrupled between 1994 and 2000. Tax receipts from capital gains realizations more than tripled during this period, even though the tax rate on capital gains was reduced beginning in 1997.

Taxable personal income grew faster than GDP during this period. Wages as a share of GDP grew from 45.7 percent in 1994 to 49.2 percent in 2000. Much of the rise in wages was related to the exercise of stock options and bonus income.



Fall in the Receipts to GDP Share: 2000 - 2004

The trend began to reverse after 2000. The decline in the stock market, the economic downturn, and the tax relief enacted in 2001 and 2003 are all explanations. Both corporate profits and wages as shares of GDP fell after 2000. Individual income taxes paid on capital gains realizations declined sharply, by 48 percent in 2001 and 25 percent in 2002. Both the share and level of wages reported on tax returns by high-income individuals fell in 2001 and 2002.

Recent Increases in Receipts: 2004 - 2007

After 2004, tax revenues again grew faster than the economy. Despite the tax relief enacted earlier in the decade, the ratio of receipts to GDP was 18.8 percent in 2007, above the 40 year average. Between 2004 and 2006, capital gains realizations grew by approximately 60 percent. Growth in corporate income tax receipts was especially strong recently, nearly doubling in levels between 2004 and 2007, and contributing a full percentage point to the increase in the total federal receipts-to-GDP share.

Looking Forward

After the recent increase, corporate receipts have dropped off considerably this year. This reversal, coupled with the cost of the Economic Stimulus Act rebates, is expected to pull the receipts-to-GDP ratio back below the historical average in 2008. However, with the tax relief of 2001 and 2003 scheduled to expire under current law, the forecast is for future revenue growth to outpace GDP, bringing the tax-to-GDP ratio well above 18.3 in the years beyond 2010.

Who Pays Most Individual Income Taxes?

The individual income tax is highly progressive – a small group of high-income taxpayers pay most of the individual income taxes each year.

- In 2005, the latest year of available data, the top 5 percent of taxpayers paid more than one-half (59.7 percent) of all individual income taxes, but reported about one-third (35.7 percent) of income.

Share of Individual Income Taxes and Income, 1990-2005

	Share of Individual Income Taxes [Share of Adjusted Gross Income]					
	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%	Bottom 50%
2005	39.4	59.7	70.3	86.0	96.9	3.1
	[21.2]	[35.7]	[46.4]	[67.5]	[87.2]	[12.8]
2000	37.4	56.5	67.3	84.0	96.1	3.9
	[20.8]	[35.3]	[46.0]	[67.2]	[87.0]	[13.0]
1995	30.3	48.9	60.8	80.4	95.4	4.6
	[14.6]	[28.8]	[40.2]	[63.3]	[85.5]	[14.5]
1990	25.1	43.6	55.4	77.0	94.2	5.8
	[14.0]	[27.6]	[38.8]	[62.1]	[85.0]	[15.0]

Source: U.S. Department of Treasury, Office of Tax Analysis.

- In 2005, the top 1 percent of taxpayers paid 39.4 percent of all individual income taxes. This group of taxpayers has paid more than 30 percent of individual income taxes since 1995.

Moreover, since 1990 this group's tax share has grown faster than their income share.

- Taxpayers who rank in the top 50 percent of taxpayers by income pay virtually all individual income taxes. In all years since 1990, taxpayers in this group have paid over 90 percent of all individual income taxes. Since 2000, this group paid over 96 percent of the total. In fact, in 2005 they were paying 96.9 percent of all individual income taxes.

The President's tax relief has shifted a larger share of the individual income taxes paid to higher income taxpayers. In 2008, with nearly all of the tax relief provisions fully in effect (e.g., lower tax rates, the \$1,000 child credit, marriage penalty relief), the projected tax share for lower-income taxpayers will *fall*, while the tax share for high-income taxpayers will *rise*.

- As a result of the President's tax relief, the share of taxes paid in 2008 by the bottom 50 percent of taxpayers is reduced from 3.4 to 3.1 percent.

Projected Share of Individual Income Taxes and Income in 2008

	Share of Individual Income Taxes ¹ [Share of Adjusted Gross Income]					
	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%	Bottom 50%
With Tax Relief	39.1	59.4	70.1	85.8	96.9	3.1
	[21.5]	[36.2]	[46.9]	[67.7]	[87.3]	[12.7]
Without Tax Relief	38.4	57.8	68.7	85.0	96.6	3.4
	[21.5]	[36.2]	[46.9]	[67.7]	[87.3]	[12.7]

Source: U.S. Treasury, Office of Tax Analysis.

^[1]Estimates of tax paid do not take into account any behavioral responses to the tax relief.

NOTE: Percentile groups begin at income of: Top 50% \$35,134; Top 25% \$69,687; Top 10% \$117,241; Top 5% \$164,594; Top 1% \$425,036.

- As a result of the President's tax relief, the share of taxes paid in 2008 by the top 1 percent of taxpayers increases from 38.4 percent to 39.1 percent.

Income Mobility

Many studies have documented the long-term trend of increasing income inequality. An important dimension of the distribution of income, however, is income mobility as households move up and down through the income distribution over time. One-time snapshots of the income distribution and comparisons of such snapshots in different years can be misleading.

A recent Treasury Department analysis shows there is a significant amount of income mobility in the U.S. economy. This analysis examined how the incomes of the same set of taxpayers changed between 1996 and 2005. Similar to other research, the study showed the movement of households across population quintiles (lowest 20 percent, etc.) over time. The table below shows the income quintiles of taxpayers in 1996 and where they end up in the overall income distribution of the tax filing population in 2005. Entries on the diagonal (in bold) indicate the percentages of taxpayers who remained in the same group ten years later, while entries off of the diagonal indicate those who moved up or down in the income distribution.

Income Mobility Relative to the Total Tax Filing Population, 1996 to 2005

1996 Income Quintile	2005 Income Quintile					Total	Top 1%
	Lowest	Second	Middle	Fourth	Highest		
	Percent						
Lowest	42.4	28.6	13.9	9.9	5.3	100.0	0.2
Second	17.0	33.3	26.7	15.1	7.9	100.0	0.1
Middle	7.1	17.5	33.3	29.6	12.5	100.0	0.3
Fourth	4.1	7.3	18.3	40.2	30.2	100.0	0.3
Highest	2.6	3.2	7.1	17.8	69.4	100.0	4.4
Top 1%	3.2	1.3	2.2	4.9	88.4	100.0	42.6
All Income Groups	13.2	16.8	19.6	23.3	27.1	100.0	1.2

Notes: Tabulations by the U.S. Department of the Treasury using data from IRS Statistics of Income, Individual Income Tax files for 1996 and 2005 for taxpayers age 25 and over in 1996.

Key findings from the table include:

- *Substantial income mobility:* More than half (56 percent in the table¹) of households moved to a higher or lower income quintile between 1996 and 2005.
- *Substantial movement out of the bottom quintile:* Roughly half (58 percent (57.6 = 100 – 42.4)) by the measure used in the table and 45 percent by another measure reported in the study) of the households initially in the bottom 20 percent of the population moved to a higher quintile by 2005.
- *The very high income are an ever changing group:* The very high income – the top 1 percent – is a group whose composition changes substantially over time, rather than a fixed group of individuals who receive a larger share of income over time. More than half (57 percent, (57.4 = 100 – 42.6)) of those in the top 1 percent in 1996 had moved to a lower income group by 2005.

¹ This number is computed by adding the percentages in the non-diagonal cells for each income quintile and dividing by 500. The diagonal cells are those that have remained in the same income quintile, while dividing by 500 adjusts for the fact that each of the rows sums to 100 for a total of 500 for all cells in the table.

These results, which are consistent with prior studies, demonstrate significant income mobility and illustrate how one-time snapshots of the income distribution provide only a partial picture of the economic situation of households by ignoring the effects of income mobility on the well-being of households over time. Moreover, the Treasury analysis shows that income mobility over the 1996 to 2005 period was virtually the same as income mobility over the prior comparable period from 1987 to 1996.

Another aspect of mobility is the extent to which the real incomes of households rose or fell over time and by how much. As the table below shows, the study also found that median after-tax incomes rose for taxpayers in all but the highest income group, with the largest percentage increases received by those initially in the lowest income groups.

- Over two-thirds of households (70.1 percent) increased their real incomes between 1996 and 2005, and median household after-tax income increased by 28.6 percent.
- Increases in real income were the largest for households with the lowest incomes in 1987.
 - Among households in the lowest income quintile in 1996, median income increased by just over 90 percent by 2005.
 - Real incomes increased over the period for nearly 82 percent of these low-income households and at least doubled for almost half of this group.
- The effects of the tax relief enacted in 2001 and 2003 and later extended through 2010 are shown by the fact that median after-tax income increased more than median before-tax income (28.6 percent versus 24.2 percent)
 - Median after-tax incomes increased by at least 3 percentage points more than before-tax income in all but the lowest income quintile (in which few taxpayers owe income tax and many receive earned income tax credits that more than offset any income tax liability).

Absolute Income Mobility: Were taxpayers better off in 2005 than in 1996?

1996 Income Quintile	After-tax cash income in 2005 compared to 1996 income in \$2005								Percent Change in:		
	Decreased more than 50%	Decreased 25 to 50%	Decreased up to 25%	Increased up to 25%	Increased 25 to 50%	Increased 50 to 100%	Increased 100% or more	Total	Median after-tax income	Median before-tax income	
	Percent										
Lowest	6.9	4.7	6.7	8.3	9.0	14.7	49.8	100.0	90.3	90.5	
Second	6.4	7.2	11.5	16.6	14.7	18.6	25.0	100.0	38.3	34.8	
Middle	5.8	9.0	14.0	20.4	16.6	19.6	14.8	100.0	26.2	23.3	
Fourth	6.8	9.4	16.1	22.4	18.7	17.5	9.0	100.0	20.7	16.6	
Highest	12.0	12.1	17.1	20.7	15.9	13.5	8.7	100.0	14.8	10.0	
Top 1%	37.3	13.9	11.9	9.4	6.9	7.2	13.4	100.0	-23.0	-25.8	
All Income Groups	7.7	8.7	13.5	18.1	15.2	16.8	20.0	100.0	28.6	24.2	

Notes: Tabulations by the U.S. Department of the Treasury using data from IRS Statistics of Income, Individual Income Tax files for 1996 and 2005 for taxpayers age 25 and over in 1996. Income is cash income less federal income tax.

How Has the President's Tax Relief Reduced the Marriage Penalty?

A couple suffers a “marriage penalty” if they owe more income tax when filing their tax return jointly than if they were unmarried and each spouse filed a separate return. The President's tax relief significantly reduced marriage penalties. As more taxpayers become subject to the alternative minimum tax (AMT) over the next decade, however, marriage penalties will rise.

Effect of the President's Tax Relief

Without the President's tax relief, 27 million married couples would have incurred \$49 billion in marriage penalties in 2008. The 2001 tax relief reduced marriage penalties in three specific ways. The standard deduction and the width of the 15-percent rate bracket for joint filers were increased, eventually phasing up to twice the levels for single filers. The 2003 and 2004 tax relief accelerated implementation of these two provisions. The 2001 tax relief also lengthened the phase-out of the earned income tax credit (EITC) for married couples. These three provisions reduce marriage penalties by \$11.1 billion in 2008 (the analysis here assumes extension of the AMT patch through 2008).

The President's tax relief also lowered marginal income tax rates. Flattening the tax rate structure and other changes will further reduce marriage penalties by \$11.7 billion in 2008.

In total, the President's tax relief reduces marriage penalties by \$22.8 billion in 2008, with 6.9 million fewer couples suffering marriage penalties.



Although marriage penalties have been substantially reduced, more than \$26 billion in marriage penalties remain for over 20 million couples. Marriage penalties persist due to other provisions in the tax code. For example, the widths of the higher tax rate brackets for joint filers are less than double the widths for unmarried filers, thereby generating marriage penalties. In fact, the top tax bracket starts at the same level for both single individuals and married couples. Similarly, other provisions, such as the AMT, give rise to marriage penalties because the income thresholds for joint filers are less than twice the corresponding amounts for unmarried filers.

Over the next decade, if no changes are made to the AMT, it will erode the marriage penalty relief provided by the 2001 and 2003 tax acts if the tax relief provided in those acts is made permanent. Joint (and other filers) will increasingly become subject to the AMT, largely because the regular tax is indexed for inflation, but the AMT is not. As more taxpayers become subject to the AMT, marriage penalties will rise.

Effect of Lowering the Top Individual Tax Rates on Flow-through Businesses

Changes in the individual income tax affect most businesses in the United States. That is because taxes on business earnings are often paid through the individual income tax when “passed-through” to business owners. The business income from sole proprietorships, farm proprietorships, partnerships, S corporations, etc., is all taxed at the owners’ individual income tax rates. This year 34 million business owners are expected to receive this type of income and pay tax on this income through the individual income tax (see table to the right).

These businesses are typically small and often entrepreneurial in nature, and a source of innovation and risk-taking in the economy. Moreover, these business owners are frequently subject to the highest individual income tax rates. The reduction in the top two tax rates enacted in 2001 and 2003 has important consequences for these businesses and the overall economy because a disproportionate share of the tax relief provided by lowering the top tax rates goes to owners of pass-through businesses.

Reduction in the top tax bracket

- About 74 percent (about 585,000) of the 790,000 tax returns that will benefit this year from lowering the top tax rate from 39.6 percent to 35 percent are flow-through business owners.
 - Nearly 325,000 of these taxpayers receive more than 30 percent of their income from flow-through businesses.
- About 82 percent (about \$23.4 billion) of the \$29.2 billion in tax relief this year from lowering the top tax rate will be received by flow-through business owners.
 - Individuals with at least 30 percent of their AGI from pass-through businesses will receive 45 percent (or about \$13.1 billion) of the total relief from lowering the top tax bracket.

Reductions in the top 2 tax brackets

- About 70 percent (about 1 million) of the 1.4 million tax returns that benefit from lowering the top two tax brackets from 39.6 percent to 35 percent, and from 36 percent to 33 percent, are flow-through business owners.
 - Nearly 540,000 of these taxpayers receive more than 30 percent of their income from flow-through businesses.
- About 81 percent (about \$27.3 billion) of the total \$33.8 billion in tax relief this year from lowering the top two tax rates will be received by flow-through business owners.
 - Individuals with more than 30 percent of their income from flow-through businesses receive 44 percent (or about \$15.0 billion) of the total tax relief from lowering the top two tax rates.

Owners of Pass-through Businesses in 2008

Type of Business	Returns (millions)
Owners of pass-through businesses:	
S Corporations	4.2
Partnerships	4.5
Sole Proprietorships	21.6
Farm Proprietorships	2.2
Individuals with rental activities	9.8
Total pass-through owners 1/	34.4

Source: US Treasury Department, Office of Tax Analysis

1/ Total is not the sum of components because some individuals are owners of more than one type of business.

Encouraging Investment

The President's tax relief has reduced the marginal effective tax rate (METR) on new investment, which is measured as the share of an investment's economic income needed to cover taxes over its lifetime. Lower METRs encourage additional investment, capital accumulation and, in the long-term, higher living standards.

- As shown in the table below, reductions in personal income tax rates (including the tax rates on dividends and capital gains) enacted in 2001 and 2003 have reduced the METR in the corporate sector by 17 percent, and in the overall economy by 16 percent.

Effect of President's tax relief on the marginal effective tax rate on new investment

	Business Sector			Owner-Occupied Housing	Economy-wide
	Corporate	Non-corporate	Total		
Without Tax Relief	31.9%	20.8%	27.6%	4.0%	19.4%
With Tax Relief 1/	26.3%	18.9%	23.4%	3.5%	16.2%
<i>% Reduction</i>	-17%	-9%	-15%	-13%	-16%

1/ Includes effects of lower regular income tax rates and lower tax rates on dividends and capital gains income, but not the temporary bonus depreciation provisions and not the manufacturing tax deduction.

- The temporary bonus depreciation provision enacted in 2002, expanded in 2003 to 50 percent, and re-enacted for 2008, provides a short-term investment stimulus. This provision lowered the METR on new equipment investment from 24.8 percent to 13.0 percent in 2002, and reduced it even further in 2003, 2004 and 2008.

Leveling the Playing Field

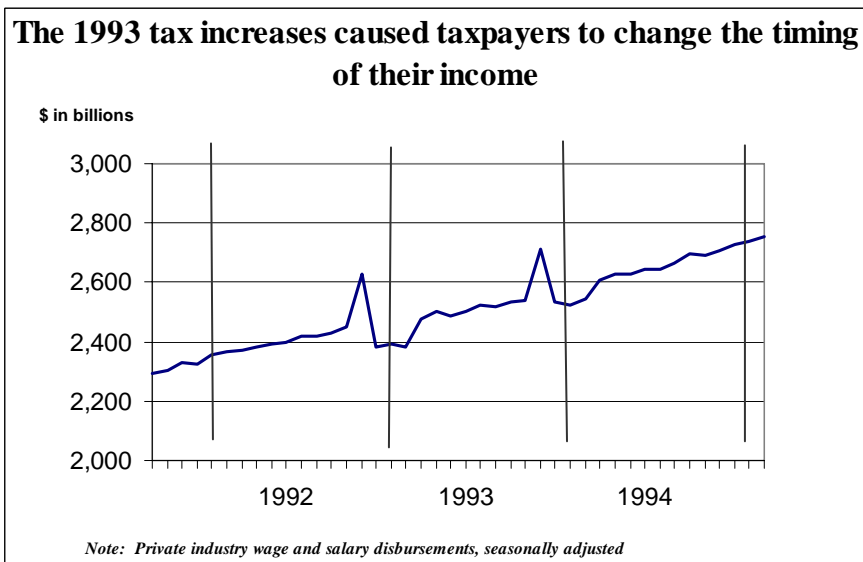
Taxing income from alternative investments at a more uniform METR – “leveling the playing field” – promotes efficient allocation of resources within the economy by allowing market fundamentals, rather than taxes, to guide financing and investment decisions.

- By lowering the tax rate on dividends and capital gains, the Jobs and Growth Tax Relief Reconciliation Act of 2003 *increased* tax uniformity by substantially reducing the METR on income from corporate equity financed investment, relative to other sources of capital income, such as debt and non-corporate income.

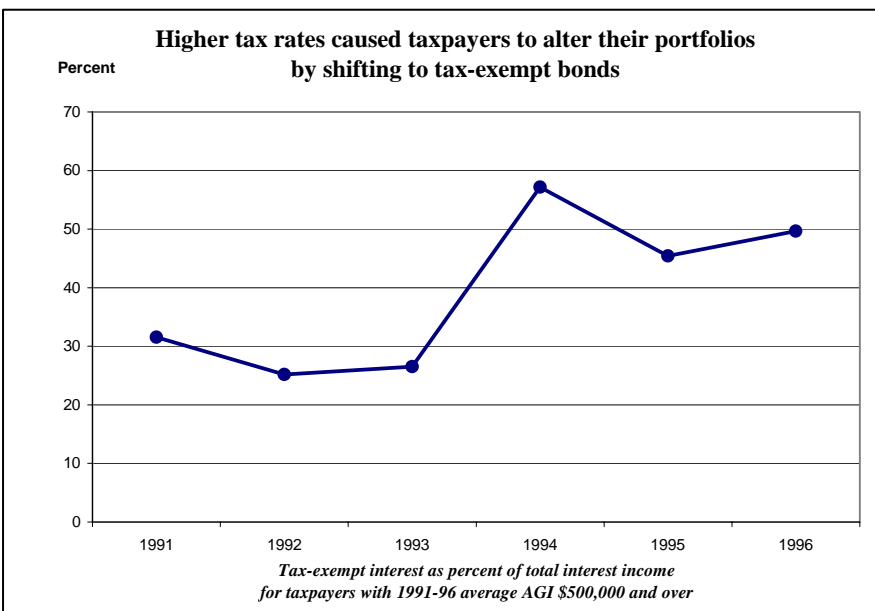
How Might Taxpayers Respond to Higher Tax Rates?

The reductions in individual income tax rates enacted in 2001 and accelerated in 2003 are scheduled to expire in 2010. How might taxpayers be expected to respond to higher tax rates in 2011? The responses to the large increases in top individual income tax rates enacted in 1993 serve as a useful guide.

One way taxpayers respond to higher tax rates is to change the *timing* of income and deductions. As illustrated in the chart to the right, high-income taxpayers accelerated the receipt of wages and year-end bonuses from 1993 to 1992 – over \$15 billion – in order to avoid the effects of the anticipated increase in the top rate from 31 percent to 39.6 percent. At the end of 1993, taxpayers shifted wages and bonuses yet again to avoid the increase in Medicare taxes that went into effect beginning in 1994. Taxpayers also shifted other income and delayed their charitable donations and other deductions in anticipation of higher tax rates.



High tax rates also have longer-term effects on taxpayers' decisions, such as the composition of their investment portfolios. The 1993 tax rate increases, for example, caused high-income taxpayers to shift their investment portfolios toward tax-exempt investments. As shown in the chart to the right, the tax-exempt interest of high-income taxpayers increased from about 30 percent to about 50 percent of total interest income. These taxpayers also likely shifted from taxable investments to non-dividend-paying stocks and tax-preferred retirement accounts. High tax rates



thus cause taxpayers to engage in otherwise unnecessary tax reduction activity. Increasing tax rates can also affect how much taxpayers save and invest, when they retire, and how much labor they supply.