

INVESTLETTER



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Who Pays the Taxes?

Wall Street:

- DJ 13372
- S&P 500 1481
- NASDAQ 2661

The rich pay the vast majority of federal income taxes in this country and they pay an even larger percentage of taxes than they did 20 years ago. So who actually pays the taxes in this country? In the media you will see accounts like my statement above implying that the rich are unfairly shouldering a growing portion of the tax burden.

Percentiles ranked by AGI	Percentage of 1986 Federal Personal Income Taxes Paid	Percentage of 2005 Federal Personal Income Taxes Paid	Change in Percentage of Taxes Paid
Top 1%	25.8%	39.4%	52.7%
Top 5%	42.6%	59.7%	40.1%
Top 10%	54.7%	70.3%	28.5%
Top 25%	77.2%	86.0%	11.4%
Top 50%	93.5%	96.9%	3.6%

As Benjamin Disraeli said: There are lies, damn lies and statistics. My opening statement falls in the latter category. Making the statement that the top 1% of taxpayers pay 40% of the taxes and that this has risen from the 26% they

paid in 1986 is aimed at creating sympathy for the poor overtaxed rich. How unfair it is for them. That is until you look into the numbers. In 1986 the top 1% of taxpayers represented 11% of adjusted gross income for the year. By 2005 the top 1% had captured 21% of the income pie. At the same time, the bottom 50% saw their share of the yearly income pie shrink from 17% in 1986 to 13% in 2005.

Is it any surprise that the pool of taxpayers that is capturing a growing share of all taxable income is actually paying more in taxes? While the taxes the rich pay as a percentage of all federal income taxes paid has risen 53%, (over the 20 years from 1986 to 2005) the income they represent has risen 91%.

Percentiles ranked by AGI	1986 % of Total AGI	2005 % of Total AGI
Top 1%	11.3%	21.2%
Top 5%	24.1%	35.7%
Top 10%	35.1%	46.4%
Top 25%	59.0%	67.5%
Top 50%	83.3%	87.2%

The question that is not being asked is how have the rich managed to see such a tremendous rise in income without a representative increase in taxes paid. If the amount of income that the top 1% of taxpayers control has risen 91% why haven't their taxes paid risen 91%?

Percentiles ranked by AGI	1986 AGI Threshold	2005 AGI Threshold	Increase in Income
Top 1%	\$118,818	\$364,657	206.9%
Top 5%	\$62,377	\$145,283	132.9%
Top 10%	\$48,656	\$103,912	113.6%
Top 25%	\$32,242	\$62,068	92.5%
Top 50%	\$17,302	\$30,881	78.5%

If I further explain that at the same time the rich have seen this favorable turn of events, the bottom 50% of taxpayers have seen the amount of taxes paid drop from 6.5% to 4% of the federal income tax bill. A 33% drop in the percentage of taxes paid. Sound like a fortunate turn of events until the fact that their

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share of the income pie has dropped by 24%. If this all starts to get confusing you are not alone, it is this characteristic that allows so many to pick and choose the sliver of information they want you to see and tailor it to buttress their particular agenda.

Maybe the tax rates paid by different income strata shown in the graph below will help clear this issue up to some extent. The top 1% paid taxes at a 33% rate in 1986. By 2005 this group paid taxes at a 23% rate, a 30% drop in the taxes paid. This helps confirm the fact that the rich have made out extremely well as a result of the tax cuts over the past twenty years. The top 50% as a whole saw the rate they pay taxes at decrease from 16% to 14% amounting to a 15% decrease in taxes. The rich benefitted by seeing their taxes cut twice as steeply as the rest of taxpayers in general (Here we consider the top

50% of taxpayers the “taxpayers in general” we referred to, because this accounts for 97% of all taxpayers).

Percentiles ranked by AGI	1986 Average Tax Rate	2005 Average Tax Rate	Decrease in percentage of Income paid in taxes
Top 1%	33.1%	23.1%	30.3%
Top 5%	25.7%	20.8%	19.0%
Top 10%	22.6%	18.8%	16.8%
Top 25%	18.7%	15.9%	15.0%
Top 50%	16.3%	13.8%	15.3%

Now back to my opening statement, the media is correct, the rich are shouldering more of the tax burden. What you often fail to hear is that this is because they have captured and even greater share of the income pie. It is only by the grace of Congress that their tax burden has been allowed lag their rise in income.

When you see a statistic like the top 1% of taxpayers paying 40% of all personal income tax it really jumps out at you. If you take the statement at face value it yields no insight into the reason behind why this is the case. To answer my own question: who pays most of the taxes, you can see it is not a question that is easily answered. So, how have the rich managed to see such a tremendous rise in income without a representative increase in taxes paid? To a large extent it is a matter of the tax policy over the past twenty years being tilted heavily in favor of the very rich. I could go on ad infinitum about tax policy but that is not the thrust of this article. Let it suffice to say that tax policy is social policy. Congress puts incentives in place to encourage certain behaviors and discourage others.

Combine this with a huge increase in executive pay, outsourcing and the lack of regular minimum wage increases and you have part of the explanation. The decrease in the tax rates on dividends and capital gains has helped the rich pay much less in taxes. Taxpayers in the top one percent report dividend income and capital gains on their returns at a much higher rate than taxpayers as a whole. As you might guess, they also report much larger amounts of dividends and capital gains. Over the next few years what changes could help even out this growing disparity (the changes in the tax burden and the stagnation of wages for lower income workers) between the haves and the have lesses? There are rarely easy fixes to complex problems. A modest increase in capital gains rates combined with more frequent minimum wage increase may allow this condition to rebalance over time. Increasing the tax on dividends and capital gains is increasing at tax that affects the rich to a larger extent than those in lower tax stratospheres. A large increase would lower investment which will have a drag on the economy. More frequent increases in the minimum wage will not affect any taxpayer who might make it into the top 50%. It will however, provide a push to wages from the bottom up. It may take a few increase to make an impact. Provided at a measured pace, modest increase to the minimum wage can provide a powerful economic stimulus by increasing disposable income in a group that tends to dispose of all of their income, often out of necessity.

The over arching goal of US economic policy should be to raise all boats. The rich have certainly had their turn over the past twenty years, now it is time for the bottom 75% to move to a new high water mark.

Reference:

Internal Revenue Service: Statistics of Income Bulletin Fall 2007, Washington, D.C. 2007