Who Really Pays Taxes in America?

Taxes and Politics in 2004

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April 15, 2004

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Fifteen years ago, socialite Leona Helmsley bragged, "only the little people pay taxes," but then she went to jail for tax fraud.[1] Unfortunately, Helmsley's statement is even more accurate today than it was at the time.

Tax fraud is estimated at $311 billion this year, more than the entire budget for Medicare and more than last year's revenues at Walmart or General Electric. Most cheaters go unpunished. What's worse, the legal tax system is rigged to favor rich people and large corporations at the expense of ordinary citizens and small businesses. Even when everybody abides by the law, middle-income households pay more taxes than rich ones. And politicians keep handing out tax favors to their campaign contributors – at our expense.

A chorus of academics, journalists, and private citizens are warning that a tax system favoring the rich fuels the growing concentration of wealth in America – and therefore threatens our economic growth and even our democracy.

Middle class spending is the growth engine in a free market economy, and when taxes rob the middle class in favor of the rich, the economy shuts down. Huge fortunes also produce political power that is hard to control. That's why all modern democracies use their tax laws to prevent excessive concentration of wealth. And that's why we need a fair taxes campaign in America.

In this election year, both candidates are certain to say a lot of things about taxes. But neither of them is likely to talk about fraud, favoritism and abuse of power – unless voters raise these issues and ask for reforms.

Who Pays Taxes?

The short answer is this: you and I pay the taxes that rich and powerful people ought to pay, but don't.

In the year 2000 – at the height of the last economic boom and before the most recent round of tax cuts were enacted – IRS data shows that the richest 400 taxpayers paid 27% of their income in federal, state, and local taxes. On average, these 400 taxpayers each had taxable income of $151 million. All other taxpayers had average taxable income of only $34,600, and yet their tax burden was 40%.[2]

Political candidates always focus on income taxes. But we have to look at *all* taxes people pay in order to grasp how our tax system has been quietly

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[1] Leona Helmsley,New York Times, July 12, 1989. Quoted in the Barlett and Steele book (see resources).
[2] IRS Report, Individual Income Tax Returns: Selected Items for Taxpayers with the Top 400 Adjusted Gross Income, 1992 to 2000.

transferring the tax burden from the wealthiest households to the rest of us for the last twenty years.

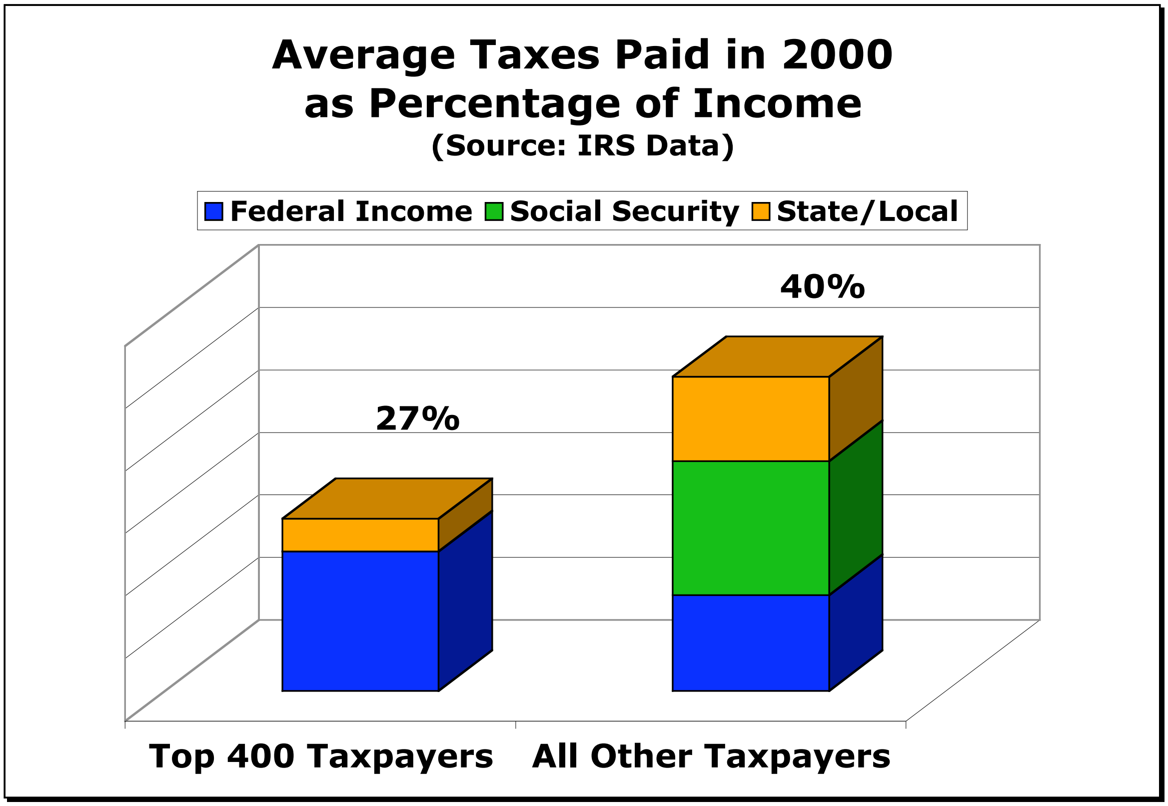

Figure 1: Richest Taxpayers Pay 33% Less Tax Than Average Households, When All Federal. State, and Local Taxes Are Combined

Journalists Donald Barlett and James Steele point out that this inequity results from a political system that has been put up for auction: "Over the last three decades, America's elected officials have turned a reasonably fair tax code into one crafted for the benefit of those who give the largest campaign contributions, enjoy the greatest access, hire the most influential lobbyists, or otherwise exercise power beyond that enjoyed by average citizens."[3]

Corporations have profited, too. In 1965, individual taxpayers paid 66% of all US income taxes, and corporations paid about a third. But by 2000, the corporate share had dropped to 18%, just about half what it used to be.[4]

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[3] *The Great American Tax Dodge*, by Donald Barlett and James Steele, Little, Brown and Company, 2000.

[4] Organization for Economic Cooperation and Development (OECD) www.oecd.org. Publishes statistics for the 30 member nations.

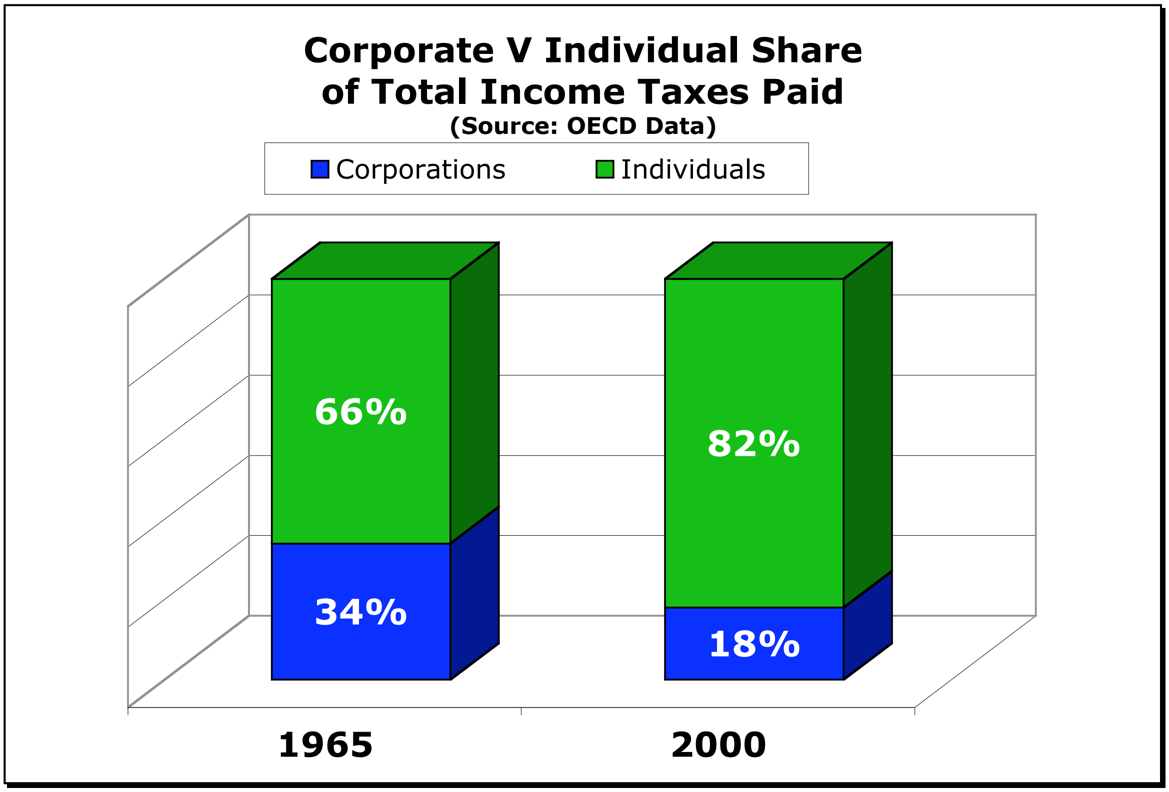

Figure 2: The Corporate Share of Taxes is Half What It Was 30 Years Ago

A recent Congressional study reported that 63% of US corporations paid no income taxes at all in 2000.[5] Six in ten American corporations reported no tax liability for the five years from 1996 through 2000, even though corporate profits were growing at record-breaking levels during that period.

The Tax Code Feeds Income Inequities and Increases the Problem of Concentrated Wealth

Not since 1929 have so few people controlled so much of the wealth in our country. In his new book, *New York Times* reporter David Cay Johnston reports that between 1970 and 2000 average income for the top 13,400 households in America increased from $3.6 million to nearly $24 million. That's a staggering 538% increase. At the same time, the average income for 90% of US households actually fell from $27,060 to $27,035. These 13,400 households account for just .001% of the population, according to Johnston.[6]

Income distribution in the United States is the most unequal among all developed nations, according to OECD data.

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[5] General Accounting Office (GAO) Report to Congress, February 2004, Comparison of the Reported Tax Liabilities of Foreign and US-Controlled Corporations, 1996-2000.
[6] *Perfectly Legal: The Covert Campaign to Rig our Tax System to Benefit the Super Rich—and Cheat Everybody Else*, by David Cay Johnston, Penguin Books, 2004. Income table on page 38.

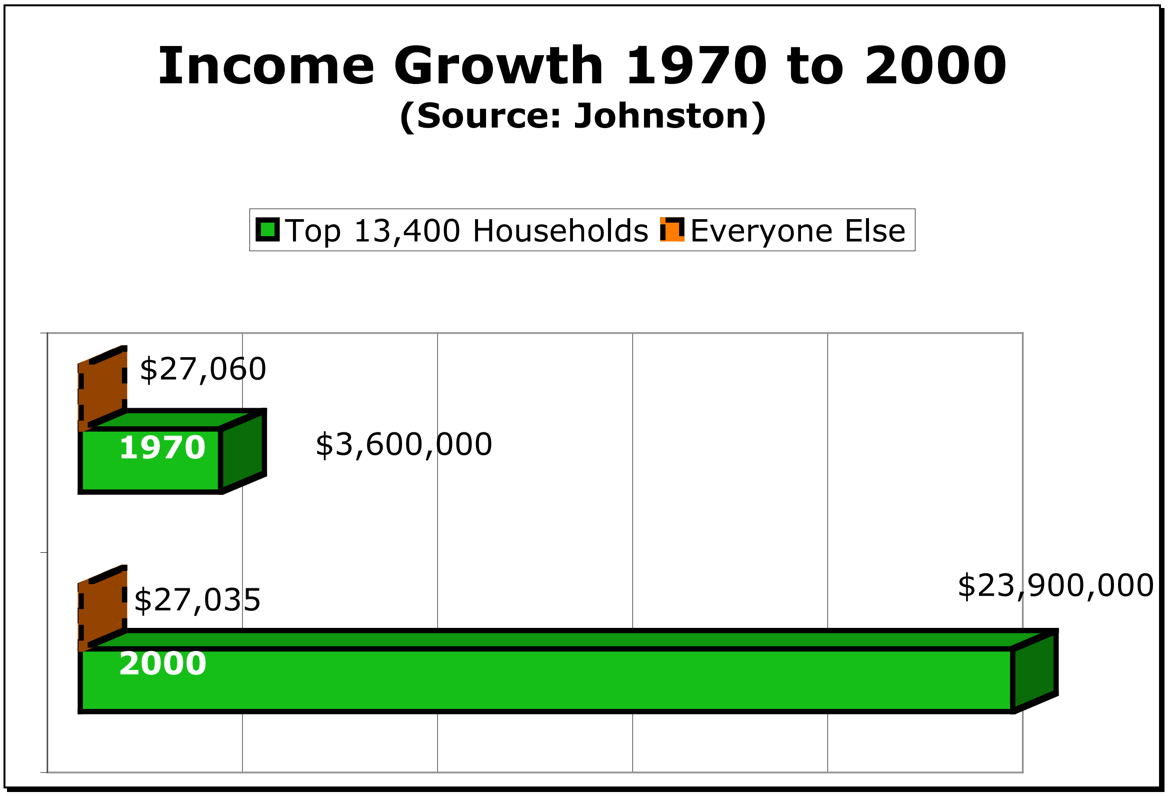

Figure 3: American Wealth is More Concentrated Than Ever Before

Prosperity that was supposed to 'trickle down' has instead flowed straight uphill. Between 1990 and 2000, the average CEO's pay increased by 571% and corporate profits grew by 93%, while workers' pay barely stayed ahead of inflation. [7]

[7] United for a Fair Economy is a Boston-based Nonprofit group that publishes a range of economic data. This report is an analysis of the annual CEO surveys published by Business Week magazines. www.ufenet.org

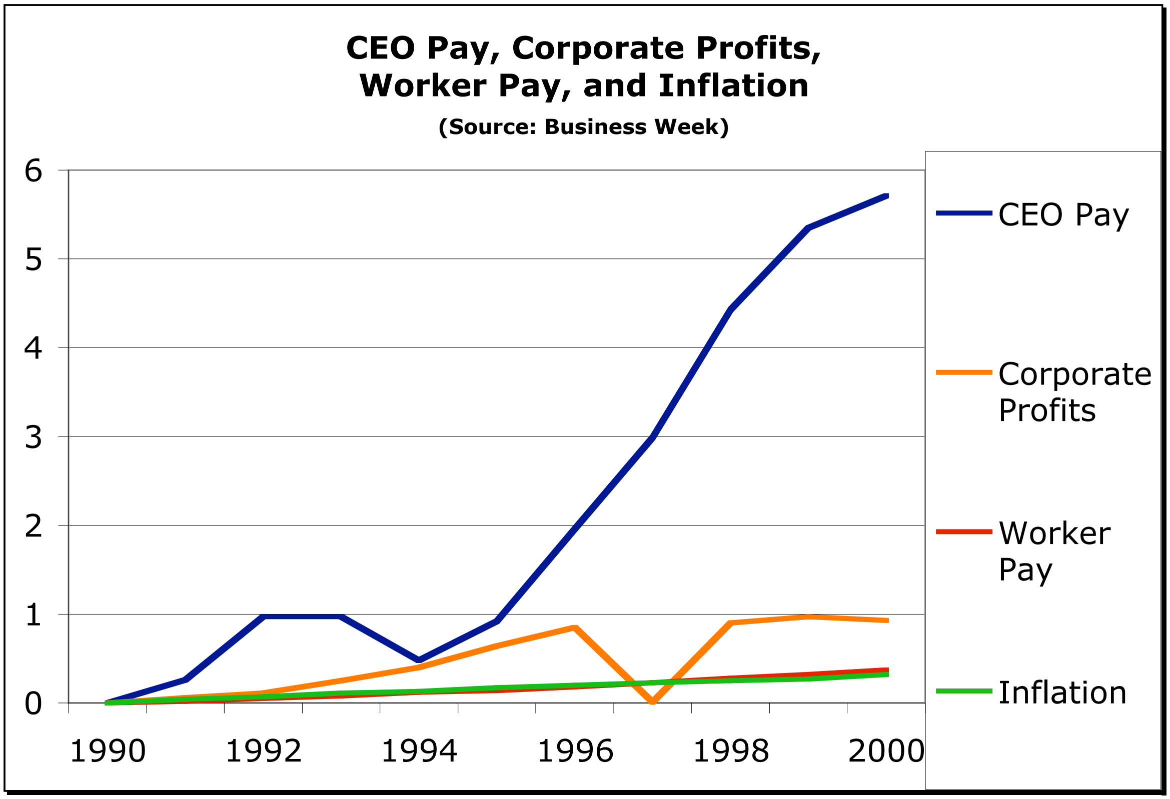

Figure 4: CEO Pay Outstrips Profits and Worker Pay

What's So Unfair About the Personal Income Tax?

Investors pay lower income taxes than workers. Roughly 85% of stock market wealth is owned by 10% of American households and there is no logical reason why income from those investments (called "capital gains" by the tax code) should be taxed less than income from work. But the top tax rate on wages is 35% while the top tax rate on capital gains is only 15%. This rate structure gives the richest households enormous advantages without producing any obvious social benefit. If we reversed the favor – and let workers pay lower tax rates than investors – then working families would have greater opportunity to accumulate wealth.

Historians point out that more people moved up into the middle class during the 1950s and 1960s – and American wealth was much less concentrated – when the top income tax rate was 91%, impacting salaries and capital gains equally.[8] According to IRS data for 2000, most American households earned 70% of their income from work and only 10% from capital gains. But in the highest tax bracket, the situation is completely reversed.[9]

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[8] Barlett and Steele, page 263.
[9] IRS Tax Statistics on the Top 400 Taxpayers,available at www.irs.gov

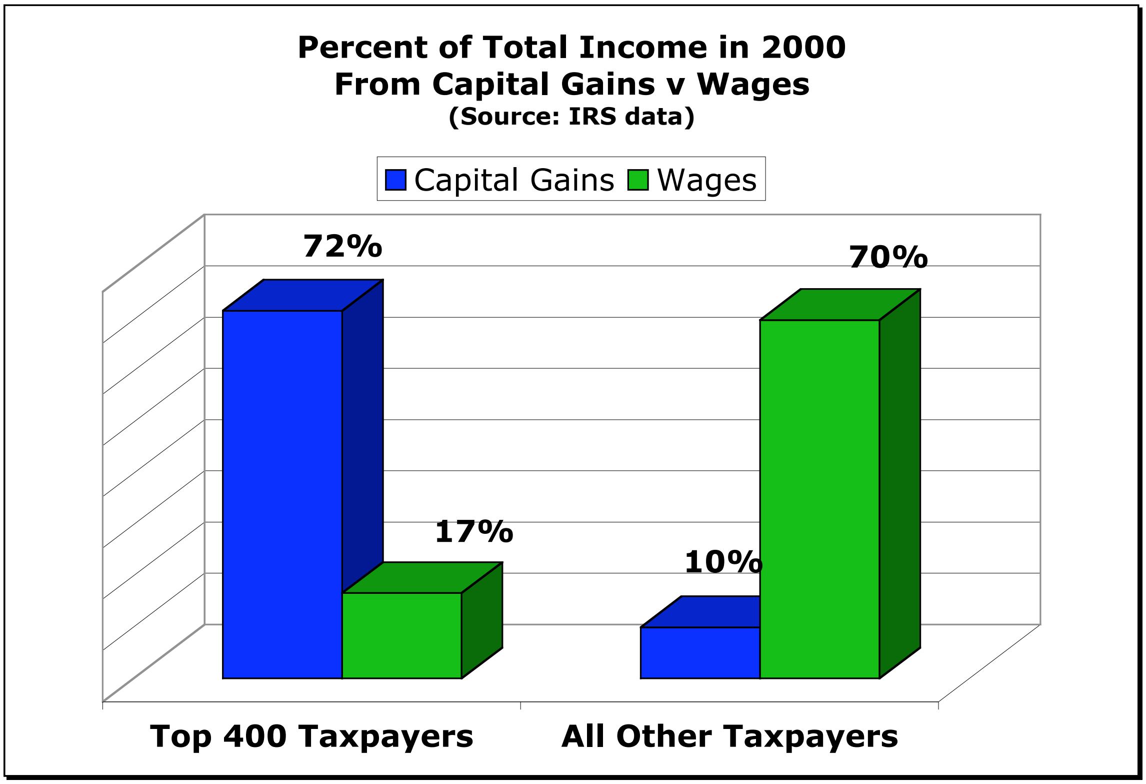

Figure 5: A Lower Tax on Investment Income Favors the Wealthiest Households Who Own Most of the Nation's Investments

Eliminating the special rate for capital gains taxes would reverse a major inequity in the current income tax. And we could reduce rampant under-reporting of capital gains income by instituting automatic withholding, just as we do with salaries.[10]

The Estate Tax Increases Income Equality By Funding Public Investments – But Gets A Death Sentence in Washington

The Federal Estate tax is the only tax that directly combats the problem of excessive accumulation of private wealth. Public investments provide American entrepreneurs with a literate work force, court-enforced property laws, and a stable business environment, among many other benefits. The estate tax recaptures some of those investments – and makes them available to future generations. Oftentimes, the assets in an estate have never been taxed.

In 2000, only 52,000 estates (out of over 2 million deaths that year) were large enough to pay estate taxes. Even though the heirs of rich families kept 75% to 80% of their family's fortunes, the tax generated vast sums for the government. According to the analysts at United for a Fair Economy, "In 2000, the estate tax alone raised more than double the total amount of federal

[10] Barlett and Steele

income taxes paid by the bottom half of American taxpayers."[11] And yet the tax is slated for extinction by President Bush.

Analysts across the political spectrum recommend keeping the estate tax. And dozens of wealthy individuals, including Bill Gates Senior and Warren Buffett, are actively working to reform but retain the estate tax. Gates, who is father to the world's wealthiest man, has recommended earmarking the proceeds for public investments, like education, that create broad-based economic opportunities.[12] Buffett, who holds the world's second-largest private fortune, joined several hundred wealthy private citizens who publicly advocated against the Bush program to eliminate estate taxes.

Excess Social Security Taxes Paid by Working Families Fund Income Tax Cuts for Wealthy Households and Corporations

The government collects more Social Security taxes than it needs for current benefits, and yet we face enormous shortfalls when the Baby Boomers retire. David Cay Johnston reports:

> From 1984 to 2002, the government collected $1.7 trillion more in Social Security taxes than the agency paid out in benefits to retirees, widows, orphans, and in disability benefits. Instead of investing that surplus to pay for the looming retirement of baby boomers, as promised, that money was used to pay the ordinary bills of the government, making up for the taxes that were no longer being paid by the rich because of the 1981 tax cuts created by Ronald Reagan.
>
> The only way that the taxes Americans have paid in advance for their Social Security benefits can be turned into retirement checks is by a new round of taxes. Because their money is gone now, Johnston says, people have lost not just what they paid, but the opportunity to invest the money for themselves.[13]

Three quarters of US households pay more Social Security taxes than income taxes. Employers deduct the tax straight out of each paycheck and send the money directly to the Federal government. A middle-income household pays 9.6% of its income in Social Security taxes, while households in the top 1% of income pay less than 2%.[14]

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[11] *Winning Responses to Tough Tax Questions,* by Marty Liebowitz, May 12, 2003 published at the website www.ufenet.org.

[12] *Wealth and Our Commonwealth: Why Americans Should Tax Accumulated Fortunes*, by William H. Gates Sr. and Chuck Collins, Beacon Press, 2003, page 137. Specifically, they recommend linking estate tax revenues to college funding.

[13] Johnston, page 118 and page 123

[14] Congressional Budget Office, Effective Tax Rates.

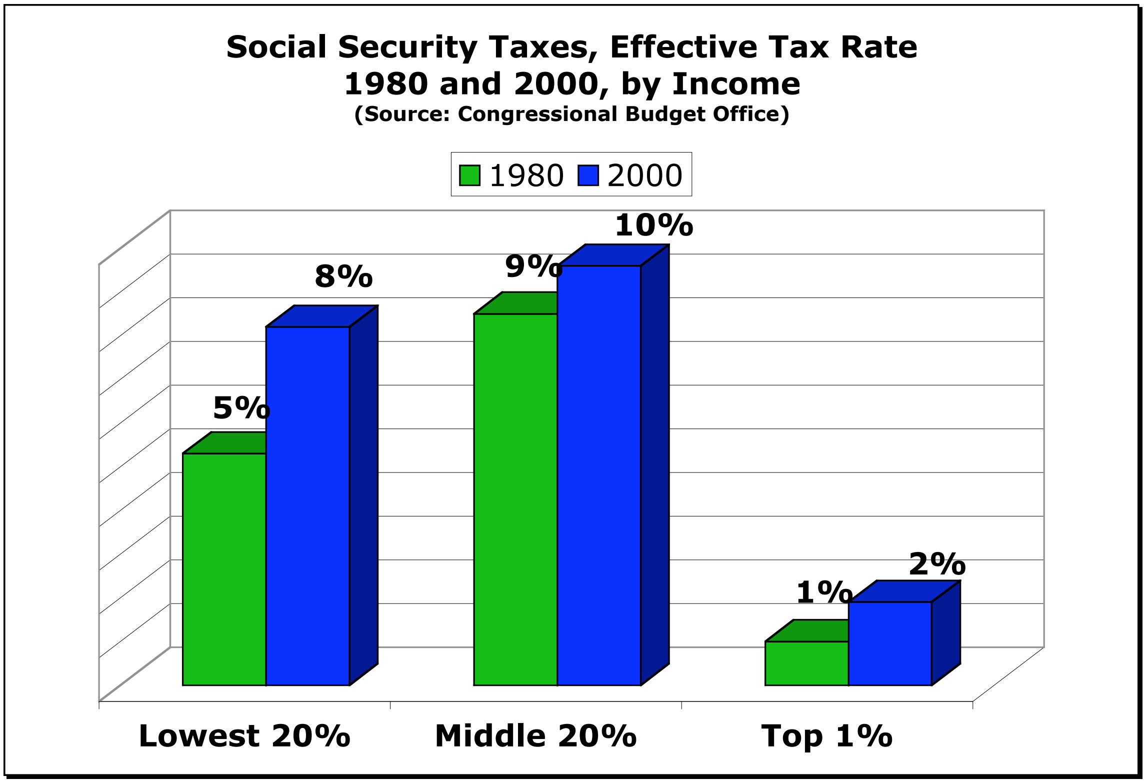

Figure 6: Low and Middle-Income Households Pay More Social Security than Income Taxes, and A Bigger Income Share than Rich Households Pay.

Social Security tax rates have increased since 1980, while income tax rates have been cut repeatedly.

During the last presidential campaign, both candidates promised not to spend the Social Security surplus. And candidate Bush specifically promised not to use the surplus to finance tax cuts. But as Johnston reports, that's just what he did: "In June 2001, President Bush signed his tax cut package that lowered rates on the rich, eliminated the estate tax for one year, and gave more than half of the $1.3 trillion tax cut to the richest 1% of taxpayers. It was a tax cut that also promised years of budget deficits . . . and more raiding of Social Security so that the middle class could subsidize the rich."[15]

The Social Security tax only applies to income up to $87,000 and people earning above that ceiling get a break from paying the tax.

Refunding excess Social Security payments now will not repair the damages already done. But we could fix the Social Security system by taxing all salaries equally – even salaries over $87,000 that are currently exempt from the tax – and by investing the funds in real assets, not government IOUs.

[15] Johnston, page 127

Cities, Counties and States Raise Taxes to Compensate for Federal Tax Cuts

When Congress cuts Federal income and estate taxes it ends up sending less money to the states – and each state has to make up the lost revenue somehow. Most states have responded by increasing their sales and excise taxes, or by cutting essential programs, or both. Many states have also cut taxes for their best-off residents. As a result, people in every state are losing libraries, childcare centers and fire stations, while paying higher bus fares, bridge tolls and sales taxes.

The federal income tax, which made up 11% of GDP in 1965, now consumes under 9% of the national income. Total taxes increased from 25% of GDP to 29% during those years, according to data from the Office of Management and Budgets (OMB), but the burden has shifted from the national government to the states.[16]

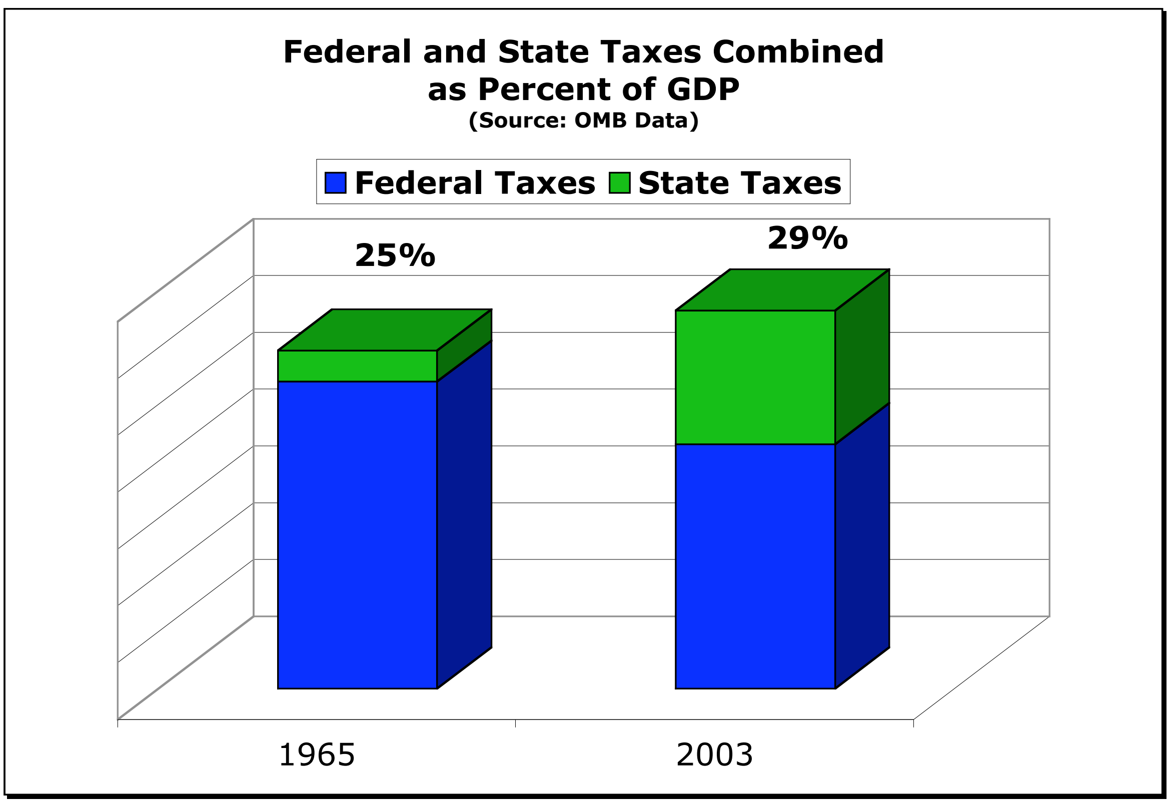

Figure 7: The Tax Burden Is Shifting From National to Local Governments

The Bush budget for 2005 cuts another $6 billion in federal support to states, and yet public investment in education, job training, child care, the

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[16] Data comes from the Office of Management and Budgets (OMB) in the White House available at http://www.gpoaccess.gov/usbudget/index.html, *Table 15.1: Total Government Receipts in Absolute Amounts and as Percentage of GDP: 1947-2002*

environment, energy, and research is already less than half what it was during the 1960s and 1970s.

States rely on regressive taxes, like sales taxes, car taxes and property taxes for their revenue. Because they impact everyone at the same rate, regardless of ability to pay, these taxes take a bigger bite from modest incomes than huge fortunes, even if the rich folks own very expensive property or buy more expensive goods.

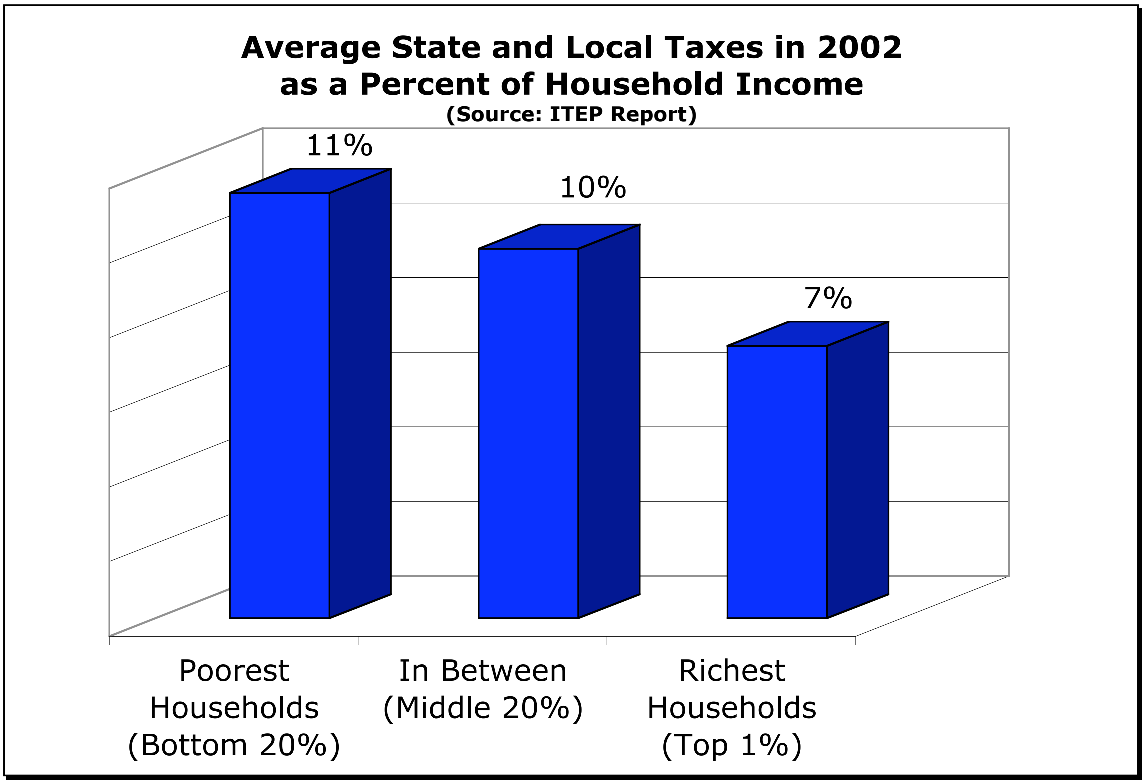

Figure 8: State Taxes Put the Greatest Burden on The Poorest Households

Because state and local taxes are regressive, as one study recently reported, "only four states require their best-off citizens to pay as much of their incomes in taxes as middle-income families have to pay."[17] Therefore, when we shift taxes from the national government to the states, we are once again shifting the burden from wealthy people to poor and middle class people. Raising taxes and collecting more revenue at the national level – and then passing the resources back to the states – would greatly increase tax equity in America.

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[17] *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, by the Institute on Taxation and Economic Policy, January 2003. Available from them through the group Citizens for Tax Justice at www.ctj.org.

Record-Breaking Tax Fraud Continues Without Any Significant Political Response

"If tax dodging were a business, it would be the nation's largest corporation," said journalists Barlett and Steele. The current $311 billion tax gap is the equivalent of the total income taxes paid annually by all individuals and families earning less than $75,000.[18]

If we simply collected the taxes cheaters are withholding from the system, we would have enough to give a free college education to every child in America, or to provide health insurance for small business employees, or to cut Social Security taxes in half. It amounts to more money than we spent for Medicare in 2003, almost as much as the Defense budget, and almost enough to pay last year's deficit.

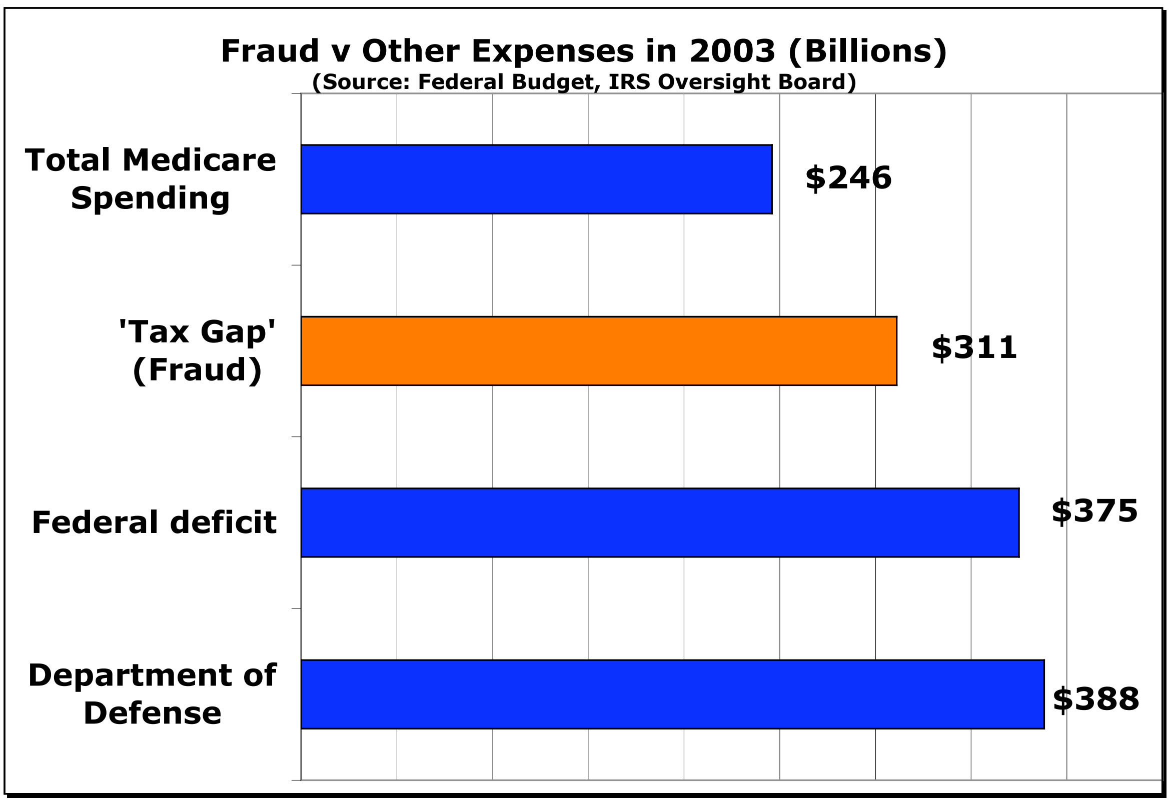

Figure 9: Americans 'Spend' More On Tax Fraud Than We Spend on Medicare

Large corporations and rich individuals have greater incentive and many more opportunities to cheat – by understating income or shipping money to foreign tax havens, by inflating deductions or claiming expenses that never existed, or by speculating in the stock market and then not reporting the gains. People

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[18] Barlett and Steele, page 13

with a job or a pension have no similar opportunity to lie about income or evade taxes.

Unfortunately, as their biggest donors turned into the biggest tax cheaters, politicians have reacted by handcuffing the tax police. Congress has consistently under-funded IRS enforcement efforts and computer upgrades that would catch more tax dodgers.[19]

Congressional misdirection of IRS resources is even worse than their failure to properly fund the agency. Statistics cited by Johnston show that the IRS polices the poor more than the rich—even though the rich have greater opportunity and incentive to cheat[20]

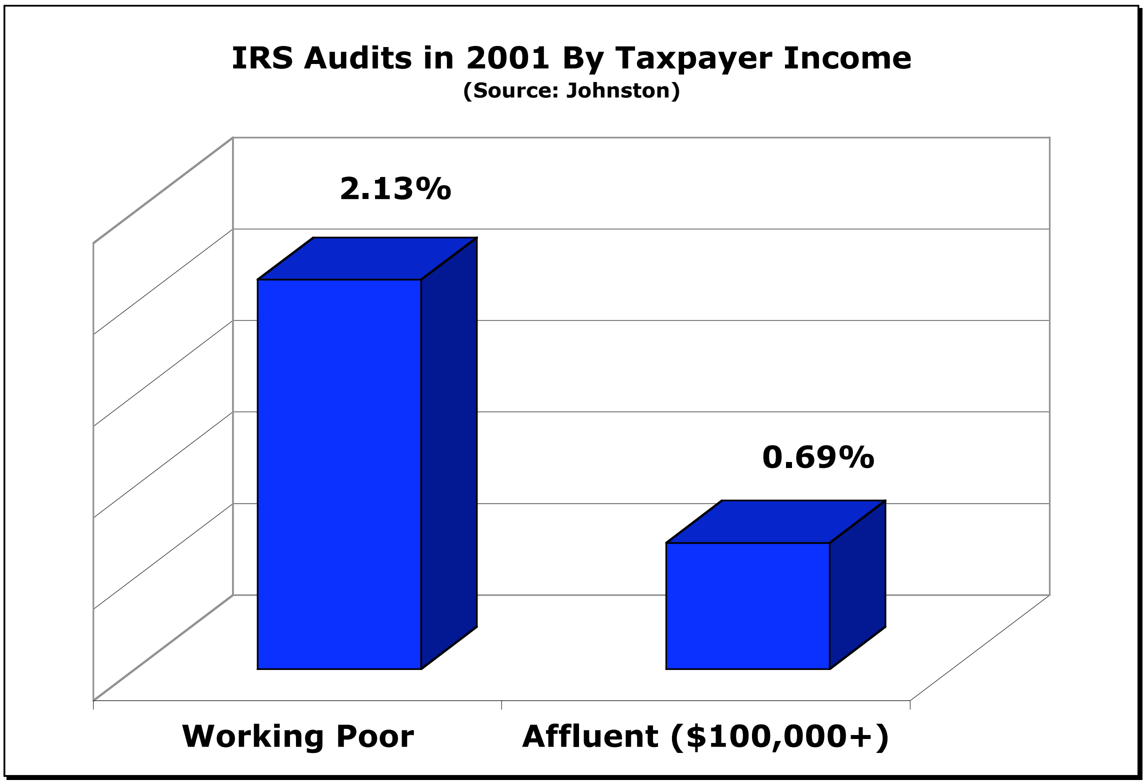

Figure 10: The IRS Audits Poor People Three Times More Frequently Than Rich Ones

Corporate tax dodgers get off easy, too: in 2002, the IRS assessed just 22 penalties against corporations, a decline of more than 99% from 1993 when 2,400 penalties were imposed. Audits of corporate returns fell sharply from 26 per 1000 returns in 1997 to just 7 per thousand returns in 2003.[21]

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[19] IRS Oversight Board, FY2005 Report.
[20] Johnston, page 134.
[21] National Profile and Enforcement Trends Over Time, by the Transactional Records Access Clearinghouse at Syracuse University. Available online at http://trac.syr.edu/tracirs/newfindings/current/

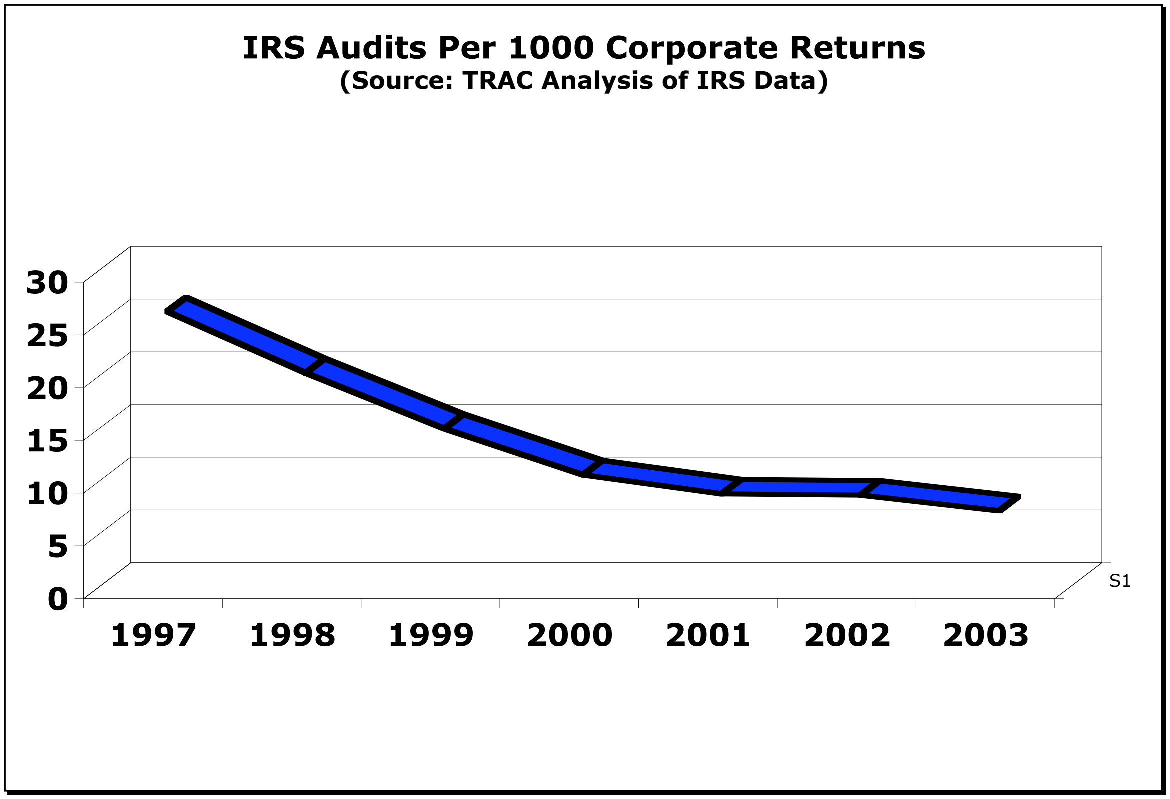

Figure 11: The IRS Only Audits 7 Out Of 1000 Corporate Tax Returns

The independent IRS Oversight Board recommends beefing up the IRS enforcement budget, targeting the biggest cheaters first (not the smaller ones), and modernizing or automating more of the IRS enforcement systems. Others have also suggested de-criminalizing tax fraud, arguing that we can catch more people – and recapture more revenue – if the penalty is a fine instead of jail.[22]

Corporate Tax Incentives Fail to Produce the Promised Economic Benefits

Corporate tax incentives have been used in the past to encourage socially valuable behavior, like locating a factory in an inner city, for example, or cleaning up pollution levels. But with corporate taxes already at their lowest levels in history, there is very little room left for further incentives. In 2000, only 8% (of more than 27 million American businesses that filed tax returns) were subject to the corporate income tax.

Current tax law favors the wrong kind of corporate behavior. Global companies can park assets overseas, for example, and evade taxes that smaller, local companies still have to pay. Corporations can also justify excessive CEO compensation and executive perks (like private jets) because the tax code

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[22] Barlett and Steele.

makes those expenses tax deductible. Economists argue that the current tax code encourages waste and fraudulent accounting.

Some claim that expensive US income taxes give advantages to foreign corporations who pay less tax in their home countries, but the evidence does not support this claim. Total federal and state corporate income taxes in the US were less than the average for other developed countries.[23]

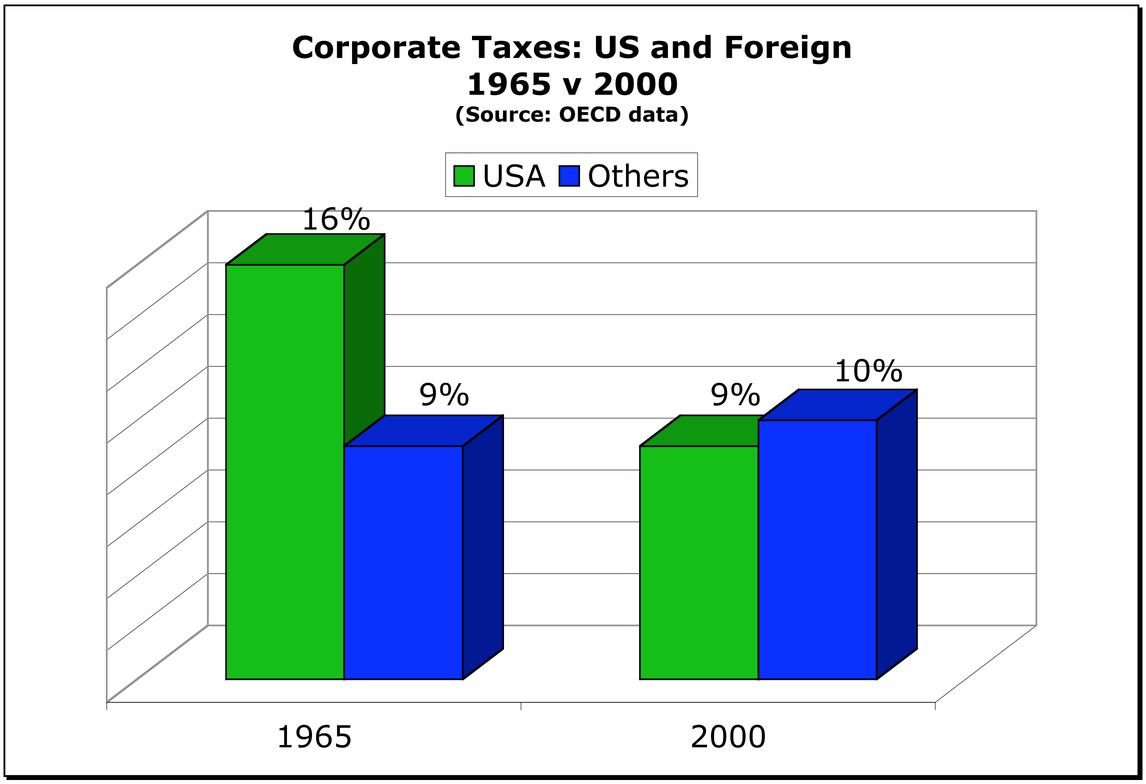

Figure 12: US Corporations Pay the Lowest Income Taxes in The World

Corporate taxes that were common in earlier generations have quietly dropped from public discussion. War profits taxes, for example, were once widely used to offset the costs of war, to share the sacrifices fairly among foot soldiers and financiers, and to prevent outright profiteering.[24] A recent issue of Newsweek magazine called for reinstituting war taxes to finance the war on terror.[25]

Special windfall profit taxes were levied against companies in the past when an unfair economic advantage resulted from unusual circumstances. For instance, when the Arab oil cartel (OPEC) hiked the world oil prices in 1973, the US government initially responded by setting price controls on American crude oil,

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[23] OECD annual report on taxes as a percentage of GDP.
[24] *Warhogs: A history of War Profits in America*, by Stuart Brandes, University Press of Kentucky, 1997
[25] "Six Fixes for the Tax Mess," by Allan Sloan, Newsweek April 12, 2004.

but then switched to a windfall profits tax. The proceeds were earmarked for energy conservation research.

Both candidates talk about corporate tax incentives, but before we consider additional tax breaks for corporations, we should evaluate the effectiveness of existing programs. Are we keeping jobs where we want them? Are we encouraging openness with shareholders and employees? Are we rewarding efficiency?

Many analysts recommend reducing corporate tax evasion, closing loopholes, and increasing economic efficiency by making corporations pay taxes on the income they report to stockholders, not a separate figure cooked up for the IRS.[26] Another recommendation: boost IRS audit rates for companies that use aggressive tax avoidance tactics.[27]

Practical Solutions to the Tax-Based Class War

Warren Buffett has famously said, "if there is a class war in America, my side is winning." In his annual letter to shareholders this year, the billionaire investment guru urged corporations to pony up on taxes, saying, "we hope our [Berkshire Hathaway corporate income] taxes continue to rise in the future—it will mean we are prospering—but we also hope that the rest of corporate America antes up along with us."

Another voice from the billionaire class, Bill Gates Senior, reminds us that public investments in our courts, schools, transit systems, public utilities, and research programs have pushed the United States to the top of the world's economy. No other investment scheme in the history of the world has been so successful, says Gates. "As taxpayers, we should take pride in the fact that the US government is the world's largest venture capitalist."[28]

We can end the apparent abuse of economic power and political influence that has led us where we are today, and get the economy growing, by revamping our tax laws and boosting public investment with the proceeds. Beyond the recommendations already offered, here are three key ways we can accomplish this goal:

- Increase Federal investments in the states, by providing funds for universal public pre-school, for example, or by offering low-cost health insurance for small businesses.

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[26] *The Great American Tax Dodge*, by Donald L. Barlett and James B. Steele, Little, Brown and Company, 2000. And also David Cay Johnston.
[27] IRS Oversight Board, FY2005 Budget Report, March 2004.
[28] *Wealth and Our Commonwealth: Why Americans Should Tax Accumulated Fortunes*, by William H. Gates Sr. and Chuck Collins, Beacon Press, 2003.

- Reinstate War and Windfall Profits taxes in selected circumstances and invest the proceeds in an all-out public effort to reduce American dependence on foreign oil.

- Sunshine the tax code so that politicians must name the beneficiaries from tax legislation they propose, and disclose donations received from them.

Previous generations of Americans addressed the political problem of concentrated wealth and power by actively breaking up monopolies, jailing people who put undue pressure on politicians, and helping disenfranchised people win the right to vote. This generation must find solutions appropriate to our own times.

References and Resources

The Tax Policy Center (www.taxpolicycenter.org) provides a wealth of tax statistics and analysis.

The Center on Budget and Policy Priorities (www.cbpp.org) goes beyond taxes to look at issues of budget priorities and economic development.

Citizens for Tax Justice (www.ctj.org) advocates for poor and middle-income families.

Responsible Wealth (www.responsiblewealth.org) is an advocacy organization headed by Bill Gates Senior and Chuck Collins.

United for a Fair Economy (www.ufenet.org) is a group working to preserve democracy from the corrupting influences of concentrated wealth.

Perfectly Legal: The Covert Campaign to Rig our Tax System to Benefit the Super Rich—and Cheat Everybody Else, by David Cay Johnston, Penguin Books, 2004.

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