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Framing the Distributional Effects of the Bush Tax Cuts

by Lawrence Zelenak

Lawrence Zelenak is Pamela B. Gann Professor of Law, Duke University, Durham, North Carolina. In this article he explains how the distributional analysis of the income tax cuts enacted during the Bush administration depends on one's choice of analytical framework. Under the framework preferred by the administration—which compares percentage reductions in income tax liabilities of taxpayers at different income levels—the tax cuts have been mildly progressive. If the focus is shifted, however, to the percentage increases in after-tax incomes attributable to the cuts, the cuts appear regressive. Even greater regressivity appears if the focus is on the distribution of raw dollars of tax cuts. Under the most comprehensive analysis of all—which considers the net effect of tax reductions and spending cuts necessitated by the tax reductions—recent legislation again appears to favor the rich at the expense of other taxpayers. After the discussion of analytical frameworks, the article consider some particular distributional aspects of recent tax legislation, relating to the alternative minimum tax, Social Security taxes, and the increasing inequality in the distribution of pretax income. It concludes with some speculation as to why the public has been so accepting of tax cuts skewed in favor of the rich. This article will appear in a collection of essays on class warfare, edited by Paul D. Carrington and Trina Jones, forthcoming from NYU Press.

Politicians proposing tax cuts seldom, if ever, want those cuts to be viewed as favoring

the rich. Whether a tax cut disproportionately benefits high income taxpayers may depend, however, on the chosen framework for distributional analysis. From one perspective a tax cut may be skewed in favor of the rich, while from another perspective the same tax cut may be proportional or even progressive. Thus, a politician who can control the analytical framework may be able to improve the chances that his proposed tax cuts will be enacted.

This essay examines how the income tax reductions enacted during the presidency of George W. Bush appear under several different distributional frameworks.¹ The paper begins with the framework advocated by the Bush Treasury Department, under which the distribution of the Bush-era tax cuts has actually been somewhat skewed *against* the rich. The essay then turns, however, to several alternative frameworks—all of them more defensible than the Treasury’s—and shows how the cuts heavily favor the rich under each alternative framework. Following the discussion of the how the Bush cuts appear under the several analytical perspectives, the essay turns to three aspects of the cuts with particularly disturbing distributional implications—the impact of the alternative minimum tax (AMT) on the tax cuts for middle class taxpayers, the relationship between the income tax cuts for the rich and the Social Security system, and the fact that the tax cuts for the rich have been enacted at a time of remarkable growth in the pretax inequality of income. The essay concludes with some thoughts as to why the American public has been supportive of the Bush tax cuts, despite the skewing of those cuts in favor of high

¹The major cuts in the individual income tax were made by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001), and by the Jobs and Growth Tax Relief Act of 2003, Pub. L. No. 108-27, 117 Stat. 764 (2003). A third piece of tax legislation enacted during the Bush administration had only a minor impact on the income tax liabilities of individuals. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (2002).

income taxpayers.

At the outset, it is worth pausing to question the strong tendency for debates on fairness in taxation to focus on the distribution of the *changes* in tax burdens caused by new (or proposed) legislation, rather than on the *absolute levels* of tax burdens under the new law. The assumption (seldom stated explicitly) must be that prior law “got it right” distributionally, and that the law is being changed only because the government’s revenue requirement has changed.²

Thus, the benefit of the tax cut (or the burden of the tax increase) should fall proportionately on taxpayers throughout the income distribution. In keeping with the usual assumption, the focus of this essay is on what it means to distribute a tax cut (or tax increase) proportionately. This is a rather narrow focus, however, and it is always possible to argue that prior law “got it wrong.” If, for example, prior law overburdened the rich, proponents of tax cuts for the rich could defend those cuts despite the fact—really, *because of* the fact—that the cuts disproportionately benefit the rich. The proponents of the Bush cuts have not, however, focused on this avenue of defense. Rather, they have claimed that the distribution of the changes in tax burdens does not favor the rich, and their argument in support of that claim is seriously flawed.

I. The Bush Administration Frameworks and Some Alternatives

A. The Administration’s Preferred Frame: Percentage Changes in Tax Liability

²In the usual—and current—situation where a tax cut necessitates government spending decreases, increased government borrowing, or both, an analysis of the distributional effects of the tax cut is incomplete with an analysis of the distributional effect of the decreased spending or increased borrowing. The analytical method favored by the Bush Treasury ignores this crucial point. For a discussion of how the analysis changes once the distributional effects of decreased government spending are considered, see part I.D of this essay.

How should we think about the distributional effects of tax cuts? To focus the question, imagine a country with just two types of citizens, the Highs and the Lows, with an equal number of each. Each High has a pretax income of \$100,000 per year, and each Low has a pretax income of \$50,000. At the beginning of the story, each High pays \$20,000 tax (for an average rate of 20%), and each Low pays \$5,000 tax (for an average rate of 10%). As a result of tax cut legislation, the tax liability of each High is then reduced to \$8,000 (average rate of 16%) and the tax liability of each Low to \$4,000 (average rate of 8%).

In 2001 and again in 2003, the Bush Treasury Department measured the distributional effects of income tax cuts by focusing on percentage reductions in income tax liabilities for taxpayers at various points in the income distribution.³ The implicit assumption of the two Treasury analyses is that a tax cut is distributionally neutral if it results in the same percentage reduction in income tax liability for taxpayers in all income classes. Any such across-the-board, equal-percentage, reduction leaves unchanged the percentage of total income taxes paid by each income class—a seemingly distributionally neutral result. In using this framework, the Bush Treasury was following the approach used successfully by Ronald Reagan in promoting and defending major tax cut legislation in 1981:

Now, of course, those having a larger tax will get a larger reduction in the number of dollars. The fellow paying a \$10,000 tax will get a \$1,000 reduction. The fellow paying a \$1,000 tax will get \$100 off. But the first one will still be paying 10 times as much as the other one. The tax rate reduction is the same percentage across the board.⁴

³Treasury Department Office of Public Affairs, Distribution Table for the President's Tax Relief Plan, March 8, 2001 (available as Tax Notes Today Doc. 2001-6977); Treasury Department Office of Public Affairs, Distributional Table for the Jobs and Growth Tax Relief Reconciliation Act of 2003, May 22, 2003 (available as Tax Notes Today Doc. 2003-12880).

⁴Ronald Reagan, Excerpts from Reagan Talk to Carpenters' Union, New York Times, September 4, 1981, at A10.

In 2001 and again in 2003, the Treasury announced that that year's tax legislation produced the smallest percentage reduction in income tax liability for the highest income group.⁵ By Treasury's standard, then, both the 2001 and 2003 cuts were progressive.⁶ With respect to the

⁵ The table below summarizes Treasury's analyses of the two tax cuts. (Note that the 2001 analysis is with respect to the President's proposal, which was similar but not identical to the changes actually enacted. The 2003 analysis is with respect to the cuts actually enacted in 2003.)

Cash Income Class (in thousands of dollars)	Percent Change in Individual Income Taxes, 2001	Percent Change in Individual Income Taxes, 2003
0 – 30	- 136.2	- 15.5
30 – 40	- 38.3	- 19.3
40 – 50	- 28.0	- 14.0
50 – 75	- 20.8	- 11.1
75 – 100	- 16.3	- 12.7
100 – 200	- 10.7	- 11.0
200 and over	- 8.7	- 10.8

Source: Treasury Department Office of Public Affairs (2001), supra note 3, and Treasury Department Office of Public Affairs (2003), supra note 3.

The highest income group, in both analyses, is taxpayers with pretax cash income of \$200,000 or more. As discussed in part I.B of this essay, use of such a broad income category masks the effect of the tax cuts on very high income taxpayers.

⁶A Report of the Congressional Budget Office, released in August 2004, confirmed the Treasury's claims, by showing that the combined effect of the 2001 and 2003 tax cuts was to reduce the percentage of total income tax paid by each of the four lowest quintiles, while increasing (by 3.8 percentage points) the percentage paid by the highest quintile. Congressional Budget Office, *Effective Federal Tax Rates Under Current Law, 2001 to 2014*, at 13 (tbl. 4) (2004). The Report also noted, however, that the combined effect of the 2001 and 2003 tax cuts on shares of *total* federal tax liability (individual and corporate income tax, payroll tax and excise tax) was quite different; the top quintile's share decreased slightly (with the greatest decrease enjoyed by the top 1 percent of the income distribution), while the shares of the middle

2003 cuts, for example, Treasury remarked:

Because the percentage reduction in income taxes is greatest for families with incomes under \$50,000, these families will pay a smaller share of the total income tax burden under the Act than they do under current law. . . . Conversely, families with incomes of \$100,000 or more receive a smaller than average percentage reduction in income taxes so they will pay a larger share of the total income tax burden under the Act than they do under current law.⁷

Returning to the country of the Highs and the Lows, the hypothetical tax cut would be viewed by the Bush Treasury as distributionally neutral, since it reduced the tax liability of each High by 20% (\$4,000/\$20,000), and it reduced the tax liability of each Low by the same 20% (\$1,000/\$5,000). It also left unchanged the percentage of the total tax paid by each income group. The Highs paid 80% of all tax before the cut (\$20,000/\$25,000), and they paid 80% of all tax after the cut (\$16,000/\$20,000). The Lows, of course, paid 20% of all tax both before and after the cut. That this is a dubious measure of distributional neutrality is suggested by a *reductio ad absurdum*. Suppose the income tax were virtually repealed, so that the Lows paid no tax and each High paid \$1 of tax. According to the Bush Treasury, this would be a highly progressive change, since the Highs paid 100% of the tax after the change, compared with only 80% before. Yet “highly progressive” does not seem to be a fair description of that hypothetical cut. By the same token, “distributionally neutral” may not be a fair description of the across-the-

and fourth quintiles increased slightly. *Id.* Interestingly, in light of the usual tendency of the public tax debate to focus on the income tax to the exclusion of other federal taxes, press coverage of the Report emphasized the total federal tax results rather than the income tax results. See, e.g., Edmund L. Andrews, Report Finds Tax Cuts Heavily Favor the Rich, *New York Times*, August 13, 2004, at A6; Jonathan Weisman, Tax Burden Shifts to the Middle; Presidential Campaigns Draw Differing Conclusions from Report, *Washington Post*, August 13, 2004, at A4.

⁷Treasury Department Office of Public Affairs (2003), *supra* note 3.

board 20% cut for the Highs and the Lows, and “progressive” may not be a fair description of the actual Bush tax cuts. The next section begins the consideration of the alternative frameworks for distributional analysis.

B. A First Alternative Frame: Percentage Changes in After-Tax Income

How is the distributional analysis of the hypothetical tax cut affected if we focus on percentage increases in after-tax incomes, instead of percentage reductions in tax liabilities? The tax cut increases the after-tax income of a High from \$80,000 to \$84,000—an increase of 5%. At the same time, the cut increases the after-tax income of a Low from \$45,000 to \$46,000—an increase of only 2.22%. By this measure, the tax cut—which would be proportional to the Bush Treasury—appears regressive. As a matter of arithmetic, if the starting point is an existing progressive tax, then any tax cut which reduces all tax liabilities by the same percentage (i.e., which is proportional in the Bush Treasury sense), will result in a larger percentage increase in after-tax income for higher income taxpayers.⁸ In fact, it is possible for a tax cut to be

⁸Let H signify High’s pretax income, L signify Low’s pretax income, t_H signify High’s average tax rate before the tax cut, and t_L signify Low’s average tax rate before the tax cut. Before the tax cut, High’s after-tax income is $H(1 - t_H)$, and Low’s after-tax income is $L(1 - t_L)$. Now suppose a tax cut reduces the average tax rate of both High and Low by the same percentage. We can indicate the effect of this cut by multiplying both t_H and t_L by c , where $0 < c < 1$ (for example, $c = .8$ would indicate the effect of a 20% tax rate cut). With the tax cut in effect, High’s after-tax income is now $H(1 - c \times t_H)$, and Low’s after-tax income is now $L(1 - c \times t_L)$. The percentage increase in High’s after-tax income as a result of the tax cut is equal to $[H(1 - c \times t_H) - H(1 - t_H)] / H(1 - t_H)$, which can be restated as $t_H(1 - c) / (1 - t_H)$. Similarly, the percentage increase in Low’s after-tax income as a result of the tax cut is equal to $[L(1 - c \times t_L) - L(1 - t_L)] / L(1 - t_L)$, which can be restated as $t_L(1 - c) / (1 - t_L)$. In comparing the two ratios (in their restated forms), notice first that if $t_H > t_L$, and $0 < c < 1$, then $t_H(1 - c) > t_L(1 - c)$. Also notice that, if $t_H > t_L$, then $(1 - t_H) < (1 - t_L)$. Since the percentage increase in High’s after-tax income has both a larger numerator and a smaller denominator than the percentage increase in Low’s after-tax income, it is necessarily a larger percentage increase.

progressive from the Bush Treasury's percentage-of-tax-liability perspective, and regressive from the percentage-of-pretax-income perspective.⁹

Given the differing—even contradictory—results produced by the two frameworks, the choice between them has obvious policy significance. A comprehensive review of tax distributional analysis methodology, prepared in 1999 by the Treasury Department's Office of Tax Analysis during the Clinton administration, concluded that the after-tax income framework was clearly superior:

The only tax burden measure with some theoretical basis is the percentage change in after-tax income. It alone provides some indication of a family's change in welfare, because after-tax income represents the family's consumption possibilities in either the current or future years. In contrast, the share of the total change in tax burdens, which is often quoted in the popular press, does not convey information on a family's relative welfare gains because it does not recognize the importance of a family's initial welfare position.¹⁰

In short, the important distributional question with respect to tax cuts is how they affect the welfare of taxpayers at various points in the income distribution, and the effect of tax cuts on welfare cannot be determined without reference to the effect of tax cuts on after-tax incomes.

As the Bush Treasury Department has abandoned the analysis of the effect of tax cuts on after-tax income, the Tax Policy Center (a joint undertaking of the Urban Institute and the Brookings Institution) has stepped into the breach. Analyzing the effect on after-tax income of

⁹For example, suppose High's tax on \$100,000 was reduced from \$20,000 to \$17,000, while Low's tax on \$50,000 was reduced from \$5,000 to \$4,000. The Bush Treasury would consider the tax cut progressive, because High's tax was reduced by 15% while Low's was reduced by 20%. On the other hand, High's after-tax income increased by 3.75% (\$3,000/\$80,000), while Low's increased by only 2.22% (\$1,000/\$45,000).

¹⁰Julie-Anne Cronin, U.S. Treasury Distributional Analysis Methodology 34 (OTA Paper 85, September 1999).

all the tax cuts (individual income, corporate income, and estate and gift) enacted during the Bush administration, the Tax Policy Center found—not surprisingly—that the percentage increases were smallest for the lowest-income taxpayers and largest for the highest income taxpayers.¹¹ The increases ranged from 0.2% for taxpayers in the lowest income quintile to 3.5% for taxpayers in the top quintile; within the top quintile the increase was 4.3% for taxpayers in the top 1% of the overall income distribution, and 5.4% for taxpayers in the top 0.1%.

By calculating the effects of the tax cuts on the top 1% and the top 0.1% percent of the income distribution, the Tax Policy Center’s analysis provides a much sharper focus on rich taxpayers than does the Treasury Department’s lumping of all taxpayers with incomes of \$200,000 or above into a single class. An even narrower focus, on the fabulously rich, is available. In 2003 the Statistics of Income Division of the Internal Revenue Service released a

¹¹ *Distribution of Enacted Bush Individual Income Tax Cuts by Percentage Change in After-Tax Income, 2004*

Income Group	% Change in After-Tax Income
Lowest 20 percent	0.2%
Second 20 percent	1.7%
Middle 20 percent	2.1%
Fourth 20 percent	2.4%
Top 20 percent	3.5%
Top 1 percent	4.3%
Top 0.1 percent	5.4%

Source: Tax Policy Center, Table 04-0009, March 18, 2004, www.taxpolicycenter.org. These TPC numbers are not directly comparable to the Bush Treasury Department’s figures on percentage changes in tax liabilities, because the TPC numbers do not separately analyze the effects of the 2001 and 2003 tax cuts.

detailed analysis of the 400 tax returns with the highest adjusted gross incomes (AGIs) in each of the years from 1992 to 2000.¹² In 2000, the minimum AGI required for membership in the “Fortunate 400”¹³ was \$86.63 million, and the average AGI for the 400 was \$173.9 million.¹⁴ The average tax rate for these 400 returns in 2000 (as a percentage of AGI) was 22.29%.¹⁵ The New York Times has calculated that current law (reflecting the 2001 and 2003 tax cuts), if applied to the 2000 incomes of the Fortunate 400, would produce an average tax rate of only 17.5%.¹⁶ Based on average pretax income of \$173.9 million, the effect of the rate reduction from 22.29% to 17.5% would be to increase after-tax income by 6.2%.¹⁷ Thus, the percentage increase in the after-tax income of the top 0.000003% exceeds even the percentage increase for the top 0.1%.

¹²Data Release, The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2000, IRS Statistics of Income Bulletin 7 (Spring 2003).

¹³Credit for the label belongs to Joel Slemrod. See Joel Slemrod, The Fortunate 400 (July 17, 2003), available at www.optr.org/fortunate400.pdf.

¹⁴Data Release, *supra* note 12, tbl. 1 (minimum AGI), and author’s calculation based on tbl. 1 (average AGI).

¹⁵*Id.*, tbl. 1. The average rate was far below the then-prevailing top marginal rate of 39.6%, primarily because 64% of the AGI of the Fortunate 400 consisted of long-term capital gains taxed at a maximum rate of 20%. *Id.*

¹⁶David Cay Johnston, Very Richest’s Share of Income Grew Even Bigger, Data Show, New York Times, June 26, 2003, at A1. The major factors causing the reduction in the average tax rate are the reduction in the top marginal tax rate from 39.6% to 35%, the reduction in the rate on most long-term capital gains from 20% to 15%, and the taxation of most dividends at the 15% rate generally applicable to long-term capital gains.

¹⁷Average after-tax income for the Fortunate 400 in 2000, under then-existing law, was \$173.9 million x (1 - .2229) = \$135.1 million. With the Bush tax cuts, average after-tax income would be \$173.9 million x (1 - .175) = \$143.5 million. The \$8.4 million increase in after-tax income is 6.2% of \$135.1 million.

C. A Second Alternative Frame: The Distribution of Dollars of Tax Cuts

The 1999 Report of the Treasury Department's Office of Tax Analysis is clearly correct in its insistence that distributional analysis of tax law changes must center on after-tax incomes. It is not so clearly correct, however, in its view that *percentage* changes in after-tax income are the appropriate focus, and in its implicit suggestion that a distributionally neutral tax cut is one which increases after-tax income by the same percentage for taxpayers at all points in the income distribution. If a tax cut is neutral when it increases all after-tax incomes by the same percentage, then a neutral tax cut will always provide more dollars of tax reduction for richer taxpayers than for poorer. Under that definition of neutrality, the rich should get bigger tax cuts in terms of dollars, simply because they had more dollars of after-tax income before the cuts. This is a rich-get-richer sort of "neutrality," which will not be self-evident to all, and may even strike some as perverse. This critique of the percentage-of-after-tax-income approach suggests yet another framework for analysis—a focus, simply enough, on absolute dollars of tax cuts, with the suggestion that a neutral tax cut would reduce the tax liabilities of all taxpayers by the same dollar amount, regardless of pretax income level. This version of neutrality will be unattainable (except for very small tax cuts), if a taxpayer's pre-cut tax liability is taken as the ceiling on the possible tax cut for that taxpayer, but there is no technical impediment to achieving this form of neutrality if negative tax rates are permitted—or, equivalently, if transfer payments can be used as well as tax cuts, so that each person receives tax-cuts-plus-transfer-payments of the same dollar amount.

It is clear that this form of neutrality was not in the minds of the architects of the Bush

tax cuts. According to the Tax Policy Center’s analysis, the average dollars of tax reductions from the combined effect of the 2001 and 2003 tax legislation increased dramatically with income: from \$17 for taxpayers in the lowest income quintile, to \$4,374 for taxpayers in the highest quintile, to \$28,187 for the top 1% of taxpayers, to \$149,516 for the top 0.1%.¹⁸ As for the Fortunate 400, application of the Bush tax cuts to their returns for the year 2000 would produce an average tax cut of about \$8.4 million.¹⁹

A variation on comparing the average dollars of tax cuts going to different taxpayers is to consider the percentages of the total dollars of tax reductions received by taxpayers at various income levels. By this standard, too, the Bush cuts are heavily skewed in favor of the rich. The bottom quintile of taxpayers received 0.3% of the total tax cuts (1.5 percent of their pro rata share), while the top quintile received 68.7% of all cuts (more than 3.4 times their pro rata share), the top 1% received 22.1% of the cuts (more than 22 times their pro rata share), and the

¹⁸*Distribution of Enacted Bush Individual Income Tax Cuts by Dollars, 2004*

Income Group	Average Reduction in Income Tax
Lowest 20 percent	\$17
Second 20 percent	\$292
Middle 20 percent	\$598
Fourth 20 percent	\$1,087
Top 20 percent	\$4,374
Top 1 percent	\$28,187
Top 0.1 percent	\$149,516

Source: Tax Policy Center, Table 04-0009, March 18, 2004, www.taxpolicycenter.org.

¹⁹See the calculations, supra note 17.

top 0.1% received 11.7% of the cuts (117 times their pro rata share).²⁰ The 22.1% share received by the top 1% exceeded the combined shares of the bottom three quintiles.

D. A Third Alternative Frame: Accounting for Reductions in Government Spending as Well as for Reductions in Tax Liabilities

All three prior analytical frameworks—the Bush Treasury’s and the two alternatives—pay no attention to the effect of decreased tax revenues on the operations of government. The distributional effects of tax cuts are considered (from one perspective or another), but the distributional effects of reduced government spending (or increased borrowing, or both) are disregarded. The third alternative frame corrects that omission, by adopting a unified tax-and-spending distributional analysis. Of all the possible frameworks for distributional analysis, this one is the most theoretically attractive, because it alone can provide a complete account of the distributional effects of tax changes. It is also the most challenging analysis to perform, because

²⁰*Distribution of Enacted Bush Individual Income Tax Cuts by Percentage of Total Tax Cuts, 2004*

Income Group	Percent of Total Income Tax Cuts
Lowest 20 percent	0.3%
Second 20 percent	4.6%
Middle 20 percent	9.4%
Fourth 20 percent	17.1%
Top 20 percent	68.7%
Top 1 percent	22.1%
Top 0.1 percent	11.7%

Source: Tax Policy Center, Table 04-0009, March 18, 2004, www.taxpolicycenter.org.

of the difficulty of determining how the burden of spending cuts (and borrowing increases) has been distributed among the citizenry.²¹

To understand how, in general terms, results under this approach will differ from those under the other analytical frameworks, return to the imaginary nation of the Highs and the Lows. Before the tax cut, each High taxpayer has \$100,000 pretax income and pays \$20,000 tax, and each Low taxpayer has \$50,000 income and pays \$5,000 tax. This gives the government \$25,000 of tax revenue, the spending of which was ignored in the previous analyses. This time, however, assume that the government expenditures financed with the \$25,000 provide \$12,500 of benefits for each High taxpayer, and also \$12,500 of benefits for each Low. Although no one knows for sure, educated speculation suggests that this pattern of the distribution of the benefit of government expenditures—roughly equal benefits across the income spectrum—is reflective of the United States today.²²

Notice that the overall effect of this tax-and-spending program is progressively redistributive, transferring \$7,500 from High to Low. High pays \$20,000 tax and receives

²¹To the extent a reduction in cash transfer payments, or easily valued in-kind transfers (such as food stamps), is clearly associated with a tax cut, the distributional analysis of the spending cuts is easy. In many cases, however, life will not be so simple—because the relationship between tax cuts and spending cuts is unclear, or because the burden of the spending cuts is difficult to allocate (as with cuts in spending on education, for example), or for both reasons.

²²Gene Steuerle, Can the Progressivity of Tax Changes be Measured in Isolation?, 100 Tax Notes 1187 (2003) (suggesting that the benefits of government expenditures may increase slightly with income); William G. Gale, Peter R. Orszag, and Isaac Shapiro, The Ultimate Burden of the Tax Cuts 13-14 (2004) (www.cbpp.org/6-2-04tax.htm) (suggesting that the benefits of government expenditures are roughly equal across income categories).

\$12,500 of spending benefits, while Low pays \$5,000 tax and receives \$12,500 of benefits.²³

Now suppose a tax cut is enacted, which is designed to increase the after-tax income of both High and Low by the same percentage (and thus is not regressive under the percentage-of-after-tax-income framework). For example, High's average rate could be reduced from 20% to 16%, and Low's average rate from 10% to 5.5%. This would increase High's after-tax income by 5% (from \$80,000 to \$84,000), and Low's also by 5% (from \$45,000 to \$47,250). This tax cut would be described as progressive by the Bush Treasury (because Low's tax liability is reduced by 45%, but High's is reduced by only 20%), and as proportional by a proponent of the percentage-of-after-tax-income approach. But how does the cut fare under tax-and-spending analysis? That depends, of course, on how the government adjusts to the decrease (of \$6,250) in its revenue. The initial response may be to maintain current spending levels by borrowing, but

²³As Steuerle explains, it is even possible to produce a progressively redistributive effect from a tax-and-spending program in which most people would perceive the allocation of both the tax burdens and the spending benefits as regressive. *Id.* at 1187. Suppose, for example, the government imposes tax at an average rate of 15% on each High taxpayer (for a tax of \$15,000) and at an average rate of 20% on each Low taxpayer (for a tax of \$10,000), and spends the \$25,000 of revenue in a way which confers a \$13,000 benefit on each High and a \$12,000 benefit on each Low. Most people would describe the tax as regressive because it imposes a higher average rate of tax on lower income taxpayers, and the spending as regressive because it confers a higher dollar benefit on higher income citizens. Yet the overall effect of the system is undeniably to redistribute \$2,000 from High (who pays \$15,000 tax and receives a \$13,000 benefit) to Low (who pays \$10,000 tax and receives a \$12,000 benefit). The explanation of the paradox is that the usual ways of thinking about the distributional effects of taxes and of spending are not consistent. Taxes are usually considered distributionally neutral if they increase proportionately with income, while spending is usually considered distributionally neutral if it confers equal dollars of benefits regardless of income level. If taxing and spending effects are analyzed consistently—either in terms of dollars of both taxes and spending benefits, or in percentage-of-income terms with respect to both taxes and spending benefits—the overall distributive effect of the tax-and-spending system becomes clear. A consistent analysis in terms of dollars is set forth above. A consistent analysis in percentage-of-income terms would note that High pays taxes equal to 15% of income but receives benefits equal to only 13% of income, while Low pays taxes equal to 20% of income and receives benefits equal to 24% of income.

that approach cannot be maintained indefinitely.²⁴ Sooner or later, government spending must be decreased. The spending cuts might be distributed in any number of ways, but a reasonable starting point might be to assume the burden of the spending cuts will be distributed in proportion to the benefits of pre-tax cut spending. If so, half of the burden of the \$6,250 reduction in spending would be borne by High, and half by Low. High's post-cut benefit from government spending would then be \$9,375 (i.e., \$12,500 - \$3,125), and Low's benefit would be the same. The tax-and-spending cuts would have decreased High's tax by \$4,000 while decreasing High's benefits by \$3,125, and would have decreased Low's tax by \$2,250 while reducing his benefits by \$3,125. The net effect of the changes would be regressive, conferring a benefit of \$875 on High at a cost of \$875 to Low. These results are summarized in the accompanying table.

Distributional Effects of Hypothetical Tax-and Spending Cuts

	a. Pre-tax income	b. Pre-cut tax liability	c. Pre-cut benefit from government spending	d. Post-cut tax liability	e. Post-cut benefit from government spending	f. Tax decrease (b - d)	g. Benefit decrease (c - e)	h. Net gain (loss) from tax-and-spending decrease
High	100,000	20,000	12,500	16,000	9,375	4,000	3,125	875
Low	50,000	5,000	12,500	2,750	9,375	2,250	3,125	(875)

²⁴As Steuerle puts it, “[I]f the government temporarily runs a deficit to finance a tax cut, taxes and spending still must be balanced over the long run; we just don’t know up front whose taxes will be raised or spending will be cut.” Steuerle, *supra* note 22, at 1187.

Thus a tax cut which appears progressive under the Bush Treasury's percentage-reduction-in-tax-liability approach, and proportional under the percentage-increase-in-after-tax-income approach, is actually regressive under a comprehensive tax-and-spending analysis. While the example is hypothetical, the Center on Budget Policy and Priorities has concluded that the Bush tax cuts are significantly regressive under this analytical framework. The CBPP study considered the distributional effects of the 2001 and 2003 tax cuts (when fully in effect and assuming they are made permanent), on the assumption that the cuts are financed by reducing the benefit of government expenditures by an equal dollar amount (\$1,520) for each family, regardless of income level.²⁵ Under this scenario, the net effect of the tax cuts and spending cuts is to reduce after-tax income by 21.1% for the bottom quintile of the income distribution, by 7.0% for the second quintile, by 3.1% for the middle quintile, and by 0.8% for the fourth quintile.²⁶ The only winning quintile is the top one, where after-tax income increases by 3.2%. Within the top quintile the biggest winners are in the top 0.1% of the income distribution, where after-tax income increases by 7.3%. In dollar terms, the net effect is to transfer \$113 billion from the bottom 80% of the income

²⁵Gale, Orszag, and Shapiro, *supra* note 22, at 8-10. The study also considers the distributional effects of the tax cuts under the alternative assumption that they are financed by a combination of spending cuts and progressive tax increases. *Id.* at 10-12. The latter scenario seems unlikely, since progressive tax increases would largely defeat the purpose of the 2001 and 2003 tax cuts.

²⁶*Id.* at 17, appendix tbl. 3.

distribution to the top 20%, with \$35 billion of the \$113 billion going to households with incomes of more than \$1 million.²⁷

II. Beyond the Framework Question: Some Particular Distributional Aspects of the Bush Tax Cuts

A. The Tax Cuts, the Alternative Minimum Tax, and Middle Income Taxpayers

By the later years of this decade, much of the skewing of the Bush tax cuts in favor of the rich will be attributable to the alternative minimum tax (AMT)²⁸; the AMT will make the Bush cuts in the regular income tax largely illusory for many middle income taxpayers, but will have little effect on the income tax cuts for the rich. The AMT functions as a shadow income tax, running alongside the regular tax. The base of the tax is “alternative minimum taxable income” (AMTI), which is defined so as to disallow many of the exclusions and deductions permitted under the regular income tax. After allowance of a substantial exemption amount,²⁹ the remaining AMTI (the “taxable excess”) is subject to an almost-flat tax (with rates of 26% and 28%), to produce a “tentative minimum tax.” If the tentative minimum tax exceeds a taxpayer’s liability under

²⁷Id. at 4, tbl. 3.

²⁸IRC §§ 55 – 58.

²⁹For 2004, the AMT exemption amount is \$58,000 for joint returns and \$45,000 for unmarried taxpayers. IRC § 55(d)(1).

the regular income tax, the taxpayer must pay both the regular tax and the amount by which the tentative minimum tax exceeds the regular tax. The effect is the same as requiring the taxpayer to pay the greater of the regular tax or the tentative minimum tax.

The first AMT was enacted in 1969, and the AMT was extensively revised by the Tax Reform Act of 1986.³⁰ As the Senate Finance Committee explained in connection with the 1986 revisions, the purpose of the tax was “to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits.”³¹ The current and projected future impact of the AMT bears little resemblance, however, to the historic purpose of the tax. The tax now functions primarily as a tax on the upper-middle class rather than on the rich, and by 2010 it will be a tax on the middle-middle class as well. According to a study by the Tax Policy Center, 55.3% of taxpayers with AGIs from \$200,000 to \$500,000 were subject to the AMT in 2003.³² By contrast, only 28.9% of taxpayers with AGIs from \$500,000 to \$1 million owed the tax, and only 19.3% of taxpayers with AGIs above \$1 million.³³ Absent new legislation, by 2010 more than one-third (36.6%) of taxpayers with AGIs from \$50,000 to

³⁰Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487; Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

³¹S. Rep. No. 313, 99th Cong., 2d Sess. 518-19 (1986).

³²Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, *The AMT: Projections and Problems*, 100 *Tax Notes* 104, 110 (tbl. 2) (2003).

³³*Id.* at 110 (tbl. 2).

\$75,000 will be subject to the AMT, as will almost three-quarters (72.9%) of taxpayers with AGIs from \$75,000 to \$100,000, and over nine-tenths of taxpayers in both the \$100,000 to \$200,000 (92.0%) and \$200,000 to \$500,000 (96.2%) AGI ranges.³⁴ Richer taxpayers, however, will mostly avoid the tax. In 2010 the AMT will apply to slightly fewer than half (49.3%) of taxpayers in the AGI range of \$500,000 to \$1 million, and to fewer than one-quarter (24.1%) of income millionaires.³⁵ Thus, taxpayers with incomes from \$50,000 to \$100,000 will be substantially more likely to owe the AMT than taxpayers with seven-figure incomes. In her 2003 Annual Report to Congress, National Taxpayer Advocate Nina E. Olson identified “the growing reach” of the AMT as the most serious problem facing taxpayers, and described the AMT as functioning “randomly, no longer with any logical basis in sound tax administration or any connection with its original purpose of taxing the very wealthy who escape taxation.”³⁶

The incidence of AMT liability is low for the highest income taxpayers because the 35% marginal rate applicable to most of their income under the

³⁴Id. at 110 (tbl. 2).

³⁵Id. at 110 (tbl. 2). Although projections for 2010 are not an exact science, another study has produced results similar to those of the Tax Policy Center’s study. Daniel Feenberg and James Poterba, *The Alternative Minimum Tax and Effective Marginal Tax Rates*, NBER Working Paper 10072 (October 2003). Feenberg and Poterba estimate that in 2010 the AMT will apply to 56.3% of taxpayers in the \$50,000 to \$75,000 range, 77.2% in the \$75,000 to \$100,000 range, 94.7% in the \$100,000 to \$200,000 range, 91.6% in the \$200,000 to \$500,000 range, and 33.3% above \$500,000. Id. at 26 (tbl. 4).

³⁶Nina E. Olson, *National Taxpayer Advocate Annual Report to Congress* iv (2003).

regular tax is substantially higher than their 28% rate under the AMT. As a result of this rate differential, they are subject to the AMT only if their AMTI is considerably greater than their regular taxable income. By contrast, AMT marginal rates are actually higher than regular income tax marginal rates for many middle class taxpayers. Three additional factors help explain the large and growing impact of the AMT on non-wealthy taxpayers. First, the rate structure and exemption amounts of the regular tax are indexed for inflation while the AMT is not; thus inflation pushes more taxpayers into the AMT each year. Second, a number of tax benefits disallowed by the AMT are not tax preferences enjoyed by wealthy investors, but the run-of-the-mill deductions of the middle class. Perhaps the best evidence of how far the AMT has strayed from its original purpose is the fact that the special 15% tax rate on capital gains and on dividends applies under the AMT as under the regular tax, but that dependency exemptions and the deduction for state and local taxes are disallowed by the AMT.³⁷ Third, the cuts in the regular income tax enacted during the Bush administration have not been accompanied by corresponding cuts in the AMT.³⁸ Combine the effects of all these factors, and the Bush-era cuts in the regular income tax will prove

³⁷IRC §§ 55(b)(3) (applying the 15% rate for purposes of the AMT as well as the regular tax), 56(b)(1)(E) (disallowing dependency exemptions under the AMT), 56(d)(1)(A)(ii) (disallowing itemized deductions for state and local taxes under the AMT).

³⁸There is one exception. The AMT exemption amounts were increased for 2003 and 2004, but they are scheduled to revert to their prior levels in 2005. IRC § 55(d)(1).

largely illusory for middle and upper-middle income taxpayers; what Congress appears to give away through the regular tax it takes back through the AMT.

The above explains the growing reach of the AMT as a technical matter, but what is the political explanation? Two possibilities come to mind. One is that the architects of the Bush tax cuts used the AMT to achieve eventually, through a two-step process, a larger tax cut than would have been politically possible if the AMT had been reduced (and indexed for inflation) when the regular tax was reduced. The failure to adjust the AMT held down the official revenue cost of the cuts,³⁹ thus attracting crucial support for the cuts from legislators concerned about their revenue effect. But (so this explanation goes) tax cut proponents expect that in a few years those same legislators will accept whatever revenue loss is required—no matter how large—to avoid the prospect of millions of middle income taxpayers angry about their AMT liabilities.⁴⁰ The other possibility is that the Bush administration and Congressional Republicans cared deeply only about tax cuts for the rich, and that they would be happy to forego the second step in the

³⁹See Burman, Gale, and Rohaly, *supra* note 32, at 107 (tbl. 1), indicating that from 2003 through 2010 the AMT is expected to raise \$660.2 billion of revenue, compared with the \$364.9 billion revenue it would have raised over the same period without the Bush reductions in the regular tax. The difference between those two amounts—\$295.3 billion—is the amount by which failure to cut the AMT along with the regular tax has held down the revenue cost of the Bush tax cuts.

⁴⁰See David Cay Johnston, *Even for Wealthy, Tax Plan's Benefits Could Vary Widely*, *New York Times*, May 15, 2001, at C1 (“Mr. Bush and Republican leaders seem to have made a decision that they would rather push through the underlying [regular] tax cut now and rely on public pressure to help them enact another tax bill in the next year or two to address the alternative tax problem.”).

two-step process if it turns out that middle income taxpayers do not insist on AMT relief.

One technical feature of the AMT—the nondeductibility of state and local income and property taxes—makes it particularly plausible that Republicans may have little interest in providing relief to the middle income victims of the AMT. Because of this feature, in 2010 the AMT will apply to a significantly higher percentage of taxpayers in high tax states than in low tax states,⁴¹ and the AMT liability per affected taxpayer will be higher in high tax states than in low.⁴² As Daniel Gross has pointed out, high tax states tend to be “resolutely Democratic.”⁴³ He speculates that Republican lack of concern about the growing reach of the AMT might be “because those most likely to fall prey to the AMT live in states that Bush-Cheney ‘04 has already written off.”⁴⁴

B. Social Security Taxes, Social Security Benefits, and the Bush Tax Cuts

The Social Security payroll tax is imposed, at the rate of 12.4%, on the first \$87,900 of a worker’s annual earnings.⁴⁵ The tax is nominally bifurcated,

⁴¹See Burman, Gale, and Rohaly, *supra* note 32, at 110 (tbl.2), predicting that in 2010 the AMT will apply to 23.5% of taxpayers in high tax states, 22.4% of taxpayers in middle tax states, and 18.6% of taxpayers in low tax states.

⁴²*Id.* at 112 (tbl. 3), predicting that in 2010 the AMT revenue per AMT taxpayer will be \$3,294 for taxpayers in high tax states, \$2,649 for taxpayers in middle tax states, and \$2,456 for taxpayers in low tax states.

⁴³Daniel Gross, *Bush’s Secret Tax on Democrats*, *Slate*, April 13, 2004.

⁴⁴*Id.*

⁴⁵IRC §§ 3101(a) (imposing 6.2% tax on employees), 3111(a) (imposing 6.2% tax on employers). The ceiling is adjusted annually for inflation. For the

with half the tax imposed on the employee and half on the employer. Economists agree, however, that the bifurcation of the tax has no economic significance and that virtually the entire burden of the tax is borne by wage earners in the form of reduced wages.⁴⁶

Viewing the payroll tax solely as a tax—rather than as part of an overall Social Security tax-and-transfer program—a flat rate tax on the first \$87,900 of wages is decidedly regressive. Moreover, if Social Security benefits are disregarded and the combined effects of the Social Security tax and the income tax are considered, the payroll tax severely undermines the apparent progressivity of the income tax. The standard justification for disaggregating the income and Social Security taxes for purposes of distributional analysis is that Social Security constitutes a self-contained tax-and-transfer system. Social Security taxes are used to pay Social Security benefits, and the apparent regressivity of Social Security taxes is offset—or more than offset—by the progressivity of the Social Security benefits formula.⁴⁷ However, this justification is only as good as its premise—that Social Security tax receipts are dedicated to the payment of Social

adjustment for 2004, see Social Security Administration, Cost-of-Living Increase and Other Determinations for 2004, 68 FR 60437 (Oct. 22, 2003).

⁴⁶Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform* 67-68 (2d ed. 2000).

⁴⁷For the benefits formula, see 42 USC § 415 (providing a schedule under which the first dollars of “average indexed monthly earnings” (AIME) are replaced at the rate of 90%, additional dollars of AIME are replaced at the rate of 32%, and the last dollars of AIME are replaced at the rate of only 15%).

Security benefits. Developments in recent years threaten to undermine that premise. Indeed, it is arguable that a significant portion of Social Security taxes is now being used to finance the Bush tax cuts for the wealthy. Understanding the argument requires a little historical background.

Until the late 1970s, Social Security was conceived and operated on a pay-as-you-go basis. Social Security taxes collected during any given year approximately equaled Social Security benefits paid during that year, and Social Security trust fund accumulations were minimal. Foreseeing the difficulty the retirement of the baby boomers would pose for pay-as-you-go Social Security (because of the anticipated low ratio of workers paying tax to retirees receiving benefits), in 1977 Congress enacted legislation providing for future increases in Social Security tax rates.⁴⁸ In the decades preceding the boomers' retirement, the increased tax receipts would exceed benefit payments, the excess would be used to create a substantial Social Security trust fund, and the trust fund would be drawn down during the boomers' retirement (so that benefit payments could then exceed current tax receipts). It quickly became apparent that the 1977 legislation was inadequate to ensure the long-term solvency of Social Security. A National Commission on Social Security Reform, chaired by Alan Greenspan, was appointed to make recommendations, and its 1983 Report⁴⁹ proposed a number of

⁴⁸Social Security Amendments of 1977, Pub. L. No. 95-216, 91 Stat. 1509 (1977).

⁴⁹Report of the National Commission on Social Security Reform (1983), available at www.ssa.gov/history/reports/gspan.html.

measures—including partial income taxation of Social Security benefits, acceleration of the future payroll tax increases called for by the 1977 Act, and a phased-in increase in the normal retirement age—designed to make Social Security solvent for the next 75 years.⁵⁰ Congress quickly followed the Commission’s advice, by enacting the Social Security Amendments of 1983.⁵¹

As a result of the 1977 and 1983 legislation, annual Social Security tax receipts now greatly exceed annual benefit payments, with the excess going to the Social Security trust fund. By the end of 2003, the trust fund had accumulated \$1.53 trillion,⁵² and the trust fund is expected to continue to grow until 2018.⁵³ In 2003 Social Security taxes of \$533.5 billion exceeded net Social Security benefits (i.e., benefits net of income taxes on benefits) of \$457.4 billion by \$76.1 billion; thus only 86% of Social Security taxes collected in 2003 were needed to pay 2003 benefits.⁵⁴

⁵⁰Despite legislative adoption of the Commission’s recommendations, the exhaustion of the trust fund, with resulting inability to pay full scheduled benefits, is now expected in 2042. 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds 8 (2004).

⁵¹Pub. L. No. 98-21, 97 Stat. 65 (1983).

⁵²2004 Annual Report, *supra* note 48, at 13 (Appendix A).

⁵³*Id.* at 8.

⁵⁴*Id.* at 4 (tbl. II.B1). The trust fund earned \$84.9 billion of interest income in 2003. *Id.* If that interest is viewed as available to pay current benefits, then only \$372.5 billion (\$457.4 billion minus \$84.9 billion) of taxes (less than 70% of total tax receipts) was needed to finance current benefits, and the remaining \$161 billion augmented the trust fund.

The trust fund assets consist of federal government bonds. Each year the trust fund lends the year's cash flow surplus to the federal government to help finance the regular (i.e., non-Social Security) activities of the government, and the trust fund receives federal debt obligations in return. When current benefits begin to exceed current tax receipts (in or around 2018), and the trust fund begins to spend down its assets to make benefit payments, that will require cash payments from the Treasury to the trust fund. Those cash payments will have to be financed by general tax revenues, by new government borrowing, or a combination of the two.

The fact that Social Security taxes exceed Social Security benefit payments, and the fact that the excess is financing the general operations of the federal government, do not necessarily undermine the view that Social Security taxes are dedicated to the payment of Social Security benefits. Since the 1977 and 1983 amendments, Social Security taxpayers have been told that they are paying higher taxes now so that the system will be able to pay their benefits when they retire. It is true that the taxes in excess of current benefit payments have been loaned to the federal government, but that is not inconsistent with the dedication of the excess taxes to Social Security, *if* the government repays the loans as the boomers retire. The trust fund can be understood as a loan from Social Security taxpayers to income taxpayers, to be repaid beginning around 2018.

The problem with this view is that there are now serious rumblings that

income taxpayers will not repay the loan—indeed cannot repay the loan, if the Bush tax cuts (most of which are currently scheduled to expire at the end of 2010) are made permanent as the Bush administration and most Congressional Republicans desire. In widely reported and remarked-on testimony to Congress in February 2004, Alan Greenspan—chairman of the Federal Reserve and of the 1983 Social Security Commission—suggested that income tax revenues would not be sufficient for the government to repay its debt to the trust fund, and that Congress should renege on its promise to future retirees by further raising the normal retirement age and by not fully adjusting Social Security benefits for inflation.⁵⁵ If Greenspan’s suggestions are adopted by Congress, the overall effect—of the 1977 and 1983 Social Security legislation, the Bush tax cuts, and the enactment of Greenspan’s proposed benefit reductions—will be the failure of wealthy income taxpayers to repay a massive loan from Social Security taxpayers of much more modest means. From a slightly different perspective, enactment of Greenspan’s proposals would mean that Social Security taxpayers have been paying hundreds of billions of dollars of extra taxes for the past several decades not so that they could receive promised Social Security benefits in retirement, but so that the rich could receive massive income tax reductions. A number of commentators have noticed the implications of Greenspan’s remarks, and have

⁵⁵Edmund L. Andrews, To Trim Deficit, Greenspan Urges Social Security and Medicare Cuts, *New York Times*, February 26, 2004, at A1.

reacted with understandable outrage.⁵⁶

The bottom line is simple enough. If Social Security taxes are being used to finance general governmental operations (as they clearly are), and if that turns out to be permanent financing rather than a loan to be repaid (as it will turn out if Congress follows Greenspan's advice), then the justification disappears for viewing the distributional effect of the still- somewhat-progressive income tax in isolation from the regressive Social Security tax. As Robert S. McIntyre recently wrote,

There's no doubt that as a quasi-pension system, Social Security is very progressive, offering benefits that are a much higher share of contributions to lower-income workers than to higher-income workers. But if the Social Security tax is used to pay for the government's regular activities, it's about as regressive a tax as one can imagine—one that rich people are nearly exempt from paying, even though they get the biggest benefits from the way we structure our society.⁵⁷

C. The Bush Tax Cuts Against a Backdrop of Increasing Inequality of Pretax Income

The Congressional Budget Office (CBO) recently published a study which included a detailed analysis of changes in the distribution of pretax income from 1979 to 2001.⁵⁸ The accompanying table, based on the CBO study, shows that the pretax income share of the top

⁵⁶See, e.g., Robert S. McIntyre, *Social Security's Zealous Raider*, *The American Prospect*, April, 2004, at 16; William Greider, *Greenspan's Con Job*, *The Nation*, March 22, 2004, at 6; David Cay Johnston, *The Social Security Promise Not Yet Kept*, *New York Times*, February 29, 2004, at sec. 4, p. 5; Gilbert E. Metcalf, *Foiled by the Shell Game*, *Boston Globe*, March 1, 2004, at A15.

⁵⁷McIntyre, *supra* note 56.

⁵⁸Congressional Budget Office, *Effective Federal Tax Rates: 1979-2001* (April 2004).

quintile of the pretax income distribution increased substantially from 1979 to 2001, while the pretax income shares of all four other quintiles decreased. In fact, the bottom half of the top quintile also saw its share decrease over that period, and even the bottom half of the top decile realized only a minor increase in its share. The only big winner was the top 1% of the income distribution, whose share increased from 9.3% to 14.8%—an increase of nearly 57%. In 1979 the top 1% had only (so to speak) 1.6 times the income share of the bottom quintile, but by 2001 the share of the top 1% was 3.5 times the size of the bottom quintile’s share. In 2001 the average pretax income of a member of the top 1% was seventy times that of the average pretax income of a member of the bottom quintile, and the top 1% of the income distribution had a larger share of pretax income (14.8%) than the two lowest quintiles combined (13.4%).

*Percentage Shares of Pretax Income, 1979 and 2001*⁵⁹

Pretax Income Category	Category’s Percentage Share of Total Pretax Income, 1979	Category’s Percentage Share of Total Pretax Income, 2001	Increase (Decrease) in Percentage Share of Pretax Income, 1979 to 2001
Lowest Quintile	5.8	4.2	(1.6)
Second Quintile	11.1	9.2	(1.9)
Middle Quintile	15.8	14.2	(1.6)
Fourth Quintile	22.0	20.7	(1.3)
Highest Quintile	45.5	52.4	6.9
Ninth Decile (80% to	15.0	14.8	(0.2)

⁵⁹Quintile and top 1% data are directly from CBO, supra note 58, table labeled “Share of Income (Percent), Pretax Income.” Other data are derived from the author from the same CBO table.

90%)			
Bottom half of top decile (90% to 95%)	9.8	10.1	0.3
95% to 99%	11.4	12.7	1.3
Top 1%	9.3	14.8	5.5

The CBO study indicates that in 2001 the minimum pretax income required for membership in the top 1% pretax income category was \$238,000, while the average income in the top 1% was \$1,050,100.⁶⁰ The tremendous difference between the group minimum and the group average suggests that disaggregating the top 1% would produce some interesting information. Although the CBO study does not break down the top 1% into smaller groups, two other studies provide more detail on how the highest income Americans have fared over the past few decades. One of those studies, by Thomas Piketty and Emmanuel Saez, covers 1913 to 1998, and includes data for (among other categories) the top 0.1% and the top 0.01% of the income distribution.⁶¹ Piketty and Saez found that in 1998 the threshold for membership in the top 0.01% of the income distribution (a group consisting of 13,100 taxpaying units) was income of \$3,620,500, and the average income within the group was \$9,970,000.⁶² This group had

⁶⁰CBO, supra note 58, tables labeled “Average Income (2001 dollars), Pretax Income,” and “Minimum Adjusted Income (2001 dollars).”

⁶¹Thomas Piketty and Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, 118 *Quarterly J. of Economics* 1 (2003).

⁶²*Id.* at 5 (tbl. I). These figures are based on a definition of income which excludes capital gains. With capital gains included in income, the 1998 income threshold for the top 0.01% was \$6,184,855, and the average income within the group was \$17,030,999. Thomas Piketty and Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, NBER Working Paper No. 8467 (2001), tbl. A6.

2.57% of all income in 1998 (257 times the group's pro rata share).⁶³ The group's share had more than quadrupled since 1979, when it was only 0.62% of all income.⁶⁴ Although the group's share of income did not increase every year between 1979 and 1998, the overall story for those two decades was of an increasing income share for the richest taxpayers—a “smooth increase in inequality,” in the words of Piketty and Saez.⁶⁵

But even the top 13,100 (0.01%) of all taxpayers is not the most exclusive group imaginable. For an even thinner slice of the truly rich, one can turn to the 2003 study by the Statistics of Income Division of the Internal Revenue Service, on the 400 tax returns reporting the highest adjusted gross incomes for each of the years from 1992 to 2000.⁶⁶ These Fortunate 400 constitute the top 0.000003% of the income distribution; one tax return in 323,434 made the cut in 2000. The minimum AGI for membership in the top 400 in 2000 was \$86,830,000, and

⁶³Piketty and Saez (2003), *supra* note 61, at 10 (tbl. II). This is based on a definition of income which excludes capital gains. Using a definition of income which includes capital gains, the group's income share in 1998 was 4.07%. Piketty and Saez (2001), *supra* note 62, tbl. A3.

⁶⁴Piketty and Saez (2003), *supra* note 61, at 10 (tbl. II). The group's 1979 share was itself an increase from the 1973 low point of 0.50%. Again, these figures are based on income excluding capital gains. With capital gains included in the income definition, the top 0.01% had an income share of 1.39% in 1979—an increase from a low point of 0.86% in 1975, but far below the 4.07% share in 1998. Piketty and Saez (2001), *supra* note 62, tbl. A3.

⁶⁵Piketty and Saez (2003), *supra* note 61, at 11.

Piketty and Saez also report that the composition of the income of the top 0.01% changed dramatically over the past few decades. In 1998, 78.1% of the income of the top 0.01% consisted of wages (44.8%) and entrepreneurial income (33.3%). *Id.* at 15 (tbl. III). The comparable figure for 1979 was only 45.0% (31.3% wages and 13.7% entrepreneurial income), which itself represented a substantial increase from the 15.8% figure (12.6% wages and 3.2% entrepreneurial income) for 1964. *Id.* As Piketty and Saez remark, “[T]oday the ‘working rich’ celebrated by Forbes magazine have overtaken the ‘coupon-clipping rentiers.’” *Id.* at 17.

⁶⁶IRS Data Release, *supra* note 12.

the average AGI for the group was \$173,915,610.⁶⁷ The top 400 had 1.09% of all AGI in 2000,⁶⁸ which was more than 360,000 times their pro rata share. The Fortunate 400 for 1992, by contrast, had only (again, so to speak) 0.52% of all AGI.⁶⁹ Thus, the AGI share of the top 400 had more than doubled in just eight years. In constant dollars, the AGI threshold for the top 400 nearly tripled over that same period, and the average AGI within the group slightly more than tripled.⁷⁰

Because the AGI of the Fortunate 400 in 2000 consisted largely of capital gains eligible for preferential rates,⁷¹ the average tax rate (as a percentage of AGI) within the group was only 22.29%.⁷² This was only moderately higher than the average tax rate for all income taxpayers in 2000—as indicated by the fact that the Fortunate 400's share of all tax liability (1.58%) did not greatly exceed the group's share of all AGI (1.09%).⁷³ The 22.29% average tax rate was actually slightly less than the 2000 average tax rates calculated by the IRS (using the same methodology) for taxpayers with AGIs from \$200,000 to \$500,000 (23.9%), and substantially less than the average tax rate for taxpayers with AGIs from \$500,000 to \$1,000,000 (28.3%).⁷⁴

⁶⁷Id., tbl. 1.

⁶⁸Id.

⁶⁹Id.

⁷⁰Id.

⁷¹Capital gains eligible for preferential rates constituted 64.01% of the AGI of the Fortunate 400 in 2000. Id.

⁷²Id.

⁷³Id.

⁷⁴David Campbell and Michael Parisi, Individual Income Tax Returns and Tax Shares,

At the beginning of the Bush administration, then, Congress was faced with a dramatic long-term trend toward greater income inequality, and with an income tax system which was actually regressive at top of the income distribution. Congress might have responded to this situation by increasing the progressivity of the income tax—to decrease the inequality of the distribution of *after-tax* income, and to correct the high-end regressivity of the income tax. As we have seen, however, the legislative response was exactly the opposite; Congress enacted tax cuts skewed in favor of the rich generally, and in favor of the super-rich in particular. As noted earlier, if the 2003 income tax law—with the Bush tax cuts in effect—were applied to the 2000 tax returns of the Fortunate 400, the average tax rate would fall from 22.29% to 17.5%.⁷⁵ (For comparison, the average tax rate in 2003 for an unmarried taxpayer with no dependents, \$100,000 AGI, and claiming the standard deduction, was 20.6%.⁷⁶)

As Joel Slemrod and Jon Bakija have explained, under optimal income tax theory the proper response to growing inequality of pretax income would be to increase the progressivity of the income tax.⁷⁷ Optimal income tax analysis, as originated by James Mirrlees⁷⁸ and developed

2000, *Statistics of Income Bulletin* (Winter 2002-2003) 6, 8 (fig. B). See also Martin A. Sullivan, *The Rich Get Soaked While the Super Rich Slide*, 101 *Tax Notes* 581, 582 (fig. 1) (2003) (a graph, based on IRS data, showing the distribution of average income tax rates in 2000, and showing that average income tax rates declined as AGI rose above \$5 million).

⁷⁵Johnston, *supra* note 16.

⁷⁶Author's calculations.

⁷⁷Joel Slemrod and Jon Bakija, *Does Growing Inequality Reduce Tax Progressivity? Should It?*, NBER Working Paper 7576 (2000). A slightly different version of the paper appears under the title, *Growing Inequality and Decreased Tax Progressivity*, as chapter 6 in Kevin A. Hassett and R. Glenn Hubbard, eds., *Inequality and Tax Policy* (2001).

⁷⁸See, e.g., James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 *Review of Economic Studies* 175 (1971).

by Mirlees and others, considers what form of tax-and-transfer system would maximize social welfare under various sets of assumptions. The insight at the heart of optimal income tax theory is that taxation for the purpose of redistribution has countervailing effects on social welfare. On the one hand, the transfer of a dollar from a richer person to a poorer person increases social welfare, because the gain of a dollar increases the poorer person's utility more than the loss of the dollar decreases the utility of the richer person. On the other hand, the taxation of the rich person's income needed to finance the redistribution decreases welfare, because of the efficiency loss associated with the labor-discouraging effect of the tax. Optimal tax analysis furnishes mathematical techniques for balancing the welfare gains from redistribution against the deadweight loss from taxation, so as to maximize social welfare. The optimal tax-and-transfer system design depends on a number of assumptions—about behavioral responses to the system, about societal “taste” for redistribution (i.e., the social welfare function), and about the distribution of income-earning abilities (i.e., wage rates) in society.

Slemrod and Bakija focus on Mirrlees' finding that the greater the inequality of the distribution of income-earning abilities in society, the higher the marginal tax rates called for by optimal income tax analysis.⁷⁹ The intuition behind this result is that the gains from redistribution become greater, relative to the efficiency cost of taxation, as the dispersion of economic skills increases.⁸⁰ Writing in 2000—shortly before the Bush tax cuts of 2001—Slemrod and Bakija noted “an apparent inconsistency between the theory of optimal income taxation and actual U.S. tax-and-transfer policy of the past two decades: the degree of progressivity has

⁷⁹Slemrod and Bakija, *supra* note 77, at 4, citing Mirrlees, *supra* note 78, at 207.

⁸⁰Mirrlees, *supra* note 77, at 207.

hardly budged, may have decreased, and certainly has not increased substantially in the face of apparently massive increases in the degree of pretax income inequality.”⁸¹ They speculated that perhaps the “political system produces outcomes in a way that is unrelated, or even opposite, from what would be predicted by the artificial construct of constrained social welfare maximization.”⁸² Of course, optimal tax theory was not intended as a predictive tool. It tells us how legislators interested in maximizing social welfare would respond to increasing inequality of pretax income, but it takes no position as to whether legislators are interested in social welfare.

Events since Slemrod and Bakija wrote suggest that Congress and the Bush administration are not interested in maximizing the welfare of Americans as a whole, but only in maximizing the welfare of the richest Americans.

III. The Politics of Tax Cuts for the Wealthy: Buying Off the Middle Class

If the American public was not clamoring in the streets for the Bush tax cuts, at the least it did not object to them. In fact, public opinion was quite favorable to both the 2001 and 2003 legislation.⁸³ What explains the public’s acceptance of tax cuts heavily skewed in favor of a

⁸¹Slemrod and Bakija, *supra* note 77, at 6.

⁸²*Id.*

⁸³See, e.g., Richard L. Berke and Janet Elder, 60% in Poll Favor Bush, But Economy is Major Concern, *New York Times*, March 14, 2001, at A1 (reporting results of New York Times / CBS Poll, that Bush tax cut plan was favored by 57% of respondents and opposed by only 36%); Humphrey Taylor, Lukewarm Support for Bush Tax Cut, *The Harris Poll* No. 35 (June 20, 2003) (reporting results of Harris poll, that 50% of respondents considered the recently-enacted 2003 tax cut “a good thing” compared with 35% who considered it a “bad thing”).

small and rich segment of the population? The Bush Treasury’s framing of tax cut distributional analysis may be part of the explanation—to the extent the public is persuaded that distributional neutrality in tax cuts means decreasing everyone’s tax liability by the same percentage, the public will be content to have the highest income taxpayers receive the bulk of the tax cut dollars. A recent paper by Larry M. Bartels, however, suggests a simpler—and perhaps more discouraging—explanation.⁸⁴ Bartels concludes that most people form their views on tax policy issues largely “on the basis of simple-minded and sometimes misguided considerations of self-interest.”⁸⁵ The implication is that people are generally willing to accept large tax cuts for the rich as long as those cuts are accompanied by small tax cuts for themselves.

Bartels’ analysis is based on his detailed examination of opinion polling from the 2002 National Election Study (NES) survey.⁸⁶ Respondents were asked whether they favored the 2001 tax cut legislation. They were also asked for their opinions on a number of related issues, including: whether they believed the rich were under-taxed or over-taxed; whether they believed the poor were under- or over-taxed; whether they believed they personally were under- or over-taxed; whether they would like to see more or less spent on government programs; whether they considered themselves conservative or liberal; and whether they considered themselves Democrats or Republicans. Even after controlling for government spending preferences,

⁸⁴Larry M. Bartels, *Homer Gets a Tax Cut: Inequality and Public Policy in the American Mind* (2003), available at www.princeton.edu/~policybriefs/bartels_taxcut.pdf. (The reference in the title is to a political cartoon showing Homer Simpson rejoicing over a tax cut of a few dollars while Mr. Burns, who is standing among bags of money representing a much larger tax cut, thinks “Sucker”.)

⁸⁵*Id.* at 21.

⁸⁶Detailed information about the survey is available at www.umich.edu/~nes.

ideology, and political party, respondents who viewed their own tax burdens as too high were significantly more likely to support the tax cut than those who did not.⁸⁷ In striking contrast, respondents' attitudes toward the tax burden of the rich had no effect on their support for the 2001 tax cut, after controlling for spending preferences, ideology, and party identification.⁸⁸

A politician could reasonably conclude from Bartels' analysis that a taxpayer who believes his own federal income tax burden is too high (which is the case with almost half of all taxpayers⁸⁹) will support *any* income tax cut, no matter how skewed it may be in favor of the rich, as long as the taxpayer perceives that there is some small tax reduction for himself. If that is correct, the Bush tax cuts were well designed to take advantage of that phenomenon. In order to ensure that the bulk of taxpayers received *some* tax reduction, the Bush cuts included three provisions, a significant portion of the benefits of which inured to the middle class—the carving out of the 10% bracket from the 15% bracket, the increase in the amount of the child tax credit, and marriage penalty relief. These three provisions constituted the vast majority of the Bush tax cuts for the bottom 80% of the income distribution; for example, the three provisions accounted for all but \$100 of the \$647 average 2004 tax cut for taxpayers in the middle income quintile.⁹⁰

⁸⁷Id. at 28, 47 (tbl. 10).

⁸⁸Id. at 28-29, 47 (tbl. 10). Bizarrely, favoring increased spending on government programs was strongly *positively* associated with support for the tax cut. Id. at 28.

⁸⁹Id. at 42 (tbl. 3). Slightly less than half of all taxpayers believe their federal income tax burden is too high, about half believe their federal income tax burden is about right, and very few believe it is too low.

⁹⁰Isaac Shapiro and Joel Friedman, Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts 20-22, 55 (appendix tbl. 6). Shapiro's and Friedman's analysis considers the effects of cuts in the estate and gift taxes, and the corporate income tax, in addition to the individual income tax.

These same three provisions, however, accounted for only 3.8% of the 2004 tax reduction for the top 1% of taxpayers (on average, \$1,320 out of \$33,672), and for only 1.2% of the 2004 tax reduction for taxpayers with incomes above \$1 million (on average, \$1,439 out of \$123,592).⁹¹ Of the tax cuts other than the three middle class provisions, more than 40% of the dollars of tax reduction in 2004 go to the top 1% of the income distribution.⁹² The 2004 revenue cost of the three middle class provisions is less than one-third of the total 2004 revenue cost of the Bush tax cuts.⁹³ The bulk of the Bush tax cuts, for the bulk of the taxpaying population, thus could have been provided at less than one-third of the total revenue cost of the overall legislation. But to put it that way may be to get the politics exactly backwards—perhaps the revenue loss from the middle class tax cuts was the cost the tax cut proponents had to accept in order to achieve their goal of massive tax cuts for the rich.

Bartels considers whether education might affect the public’s tendency to support large tax cuts for the rich when packaged with small cuts for the rest of the population. Finding that the least politically informed respondents in the NES survey overwhelmingly supported the 2001 tax cut, while the best informed respondents were about evenly divided on the merits of the cut, Bartels remarks: “If we are willing to take this cross-sectional difference in views as indicative of the impact of information on political preferences, it appears that the strong plurality support

⁹¹Id. at 55 (appendix tbl. 6).

⁹²Id. at 21.

⁹³Id. at 51 (tbl. 3). The estimated cost of the three provisions is \$91 billion, and the estimated total revenue cost is \$276 billion.

of Bush's tax cut . . . is attributable to simple ignorance."⁹⁴ It is one thing to conclude that the politics of tax cuts would be different if the electorate were better informed; it is a different and much more difficult thing to accomplish the necessary education—especially when a great deal of political power is held by those with a vested interest in the continuation of the status quo. Bartels himself sums up the prospects for the electorate's achieving enlightened self-interest on matters of tax policy in two words: "Not likely."⁹⁵

Middle class taxpayers are not demanding tax cuts—not even for themselves, let alone for the rich. Politicians do not *need* to enact tax cuts to satisfy the electorate. But if politicians *want* to enact tax cuts for the rich,⁹⁶ they will not face hostility from their non-rich constituents, as long as the big tax cut dollars for the rich are accompanied by a few dollars for the masses. There may come a time when voters will rebel at the budget deficits resulting from those cuts—especially if they perceive the deficits as threatening their Social Security benefits—but until that time the only limits on the ability of Congress to cut taxes for the rich may be those imposed by the consciences of its members.

⁹⁴Bartels, *supra* note 84, at 33.

⁹⁵*Id.* at 37.

⁹⁶For an interesting review of the evidence concerning the ability of the wealthy to influence the actions of members of Congress, see James R. Repetti, *Democracy, Taxes and Wealth*, 76 N.Y.U. L. Rev. 825, 843-49 (2001).