Federal Taxation of Earnings versus Investment Income in 2004

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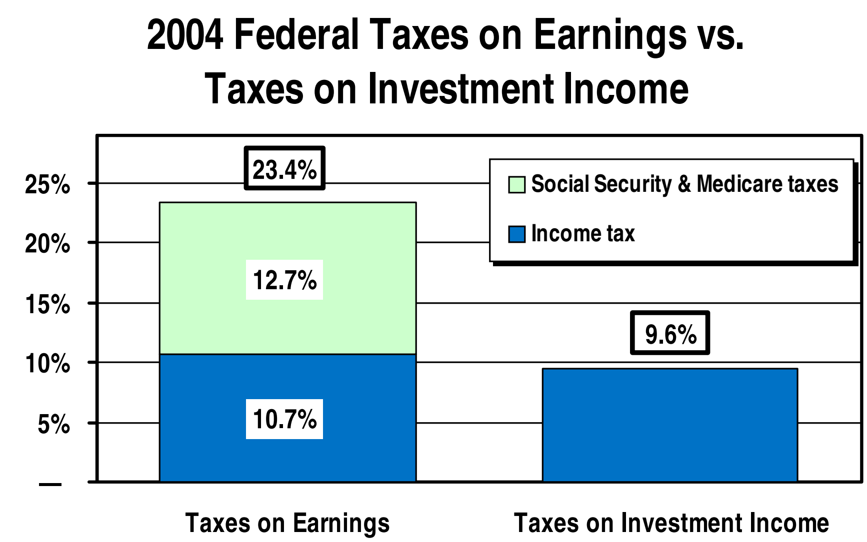
As a result of President George W. Bush's 2003 tax cut, the top federal personal income tax rate on capital gains and dividends is now only 15 percent. That is considerably less than half the 35-percent top income tax rate on earnings, and well below the marginal income-and-payroll-tax rate on wages for typical workers (which exceeds 30 percent). Some backers of the 2003 change, such as anti-tax activist Grover Norquist, say that it is only a prelude to their long-term goal of eliminating federal taxes on *all* investment income — not just dividends and capital gains, but real-estate profits, interest, etc.

How do personal taxes on *total* investment income compare to taxes on earnings right now? This paper addresses that question. The analysis includes both the individual income tax, which applies in varying degrees to both earnings and investment income, and Social Security and Medicare taxes, which apply only to wages and self-employment earnings.

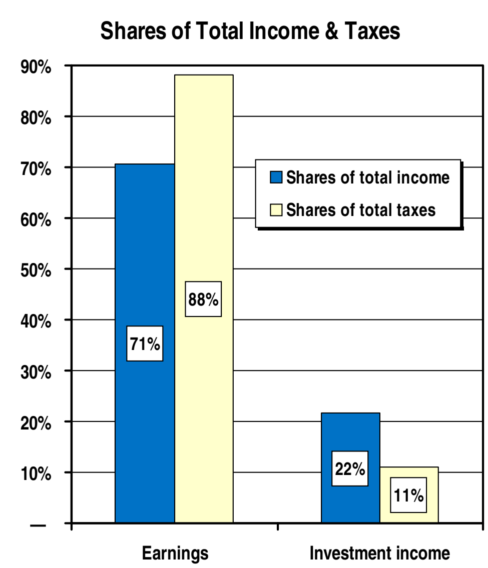


The central finding of this study is that, on average, the federal government now taxes earnings at two-and-a-half times the effective tax rate it imposes on personal investment income. Specifically:

- Total federal personal taxes paid on wages and other earnings currently average 23.4 percent. This includes an average income-tax rate of 10.7 percent on earnings, plus average Social Security and Medicare taxes of 12.7 percent.
- In contrast, federal personal taxes on investment income average only 9.6 percent.

Put another way:

- Wages and other earnings are 71 percent of total personal income, but taxes on earnings make up 88 percent of total federal personal taxes.
- In contrast, investment income is 22 percent of total personal income, but taxes on investment income are only 11 percent of total personal taxes.



The following table shows the breakdown of income and tax shares among earnings, investment income and (mostly untaxed) transfers (i.e., welfare, Social Security benefits, etc.):

Shares of Income & Taxes	Wages & other earnings	Investment income	Transfers	All
Shares of Total Income	**71%**	**22%**	**8%**	**100%**
Shares of Taxes—				
Income taxes	77%	21%	2%	**100%**
Soc.Sec. & Med. tax	100%	—	—	**100%**
Both Taxes	**88%**	**11%**	**1%**	**100%**

Why is investment income taxed so lightly compared to earnings?

Absent special treatment, the federal personal income tax would naturally tax investment income more heavily than earnings, simply because investment income is so concentrated at the top of the income scale where the regular tax brackets are highest. Some 43.1 percent of total investment income goes to the best-off one percent of taxpayers, compared to this group's 12.4 percent share of total earnings.

Indeed, if just the personal income tax treated investment income like earnings, then taxes on investment income would almost double from what they are today — to about 19 percent of total investment income. That would be still be less than the 23 percent total tax rate paid on earnings — but the gap would be much smaller.

There are several reasons why investment income is taxed far more lightly than earnings:

- First of all, earnings are taxed twice at the personal level. The 2.9 percent Medicare tax applies to all reported wages and self-employment income. The 12.4 percent Social Security tax applies to earnings up to $87,900 per worker.[1] Overall, Social Security and Medicare taxes actually take a larger share of earnings (12.7 percent) than do income taxes (10.7 percent). But investment income is exempt from helping to support Social Security and Medicare.
- Second, several types of investment income are explicitly taxed at lower income tax rates than earnings. In particular, realized long-term capital gains and eligible dividends are taxed at a maximum rate of 15 percent—compared to a 35 percent top income tax rate on earnings—and interest on state and local bonds is untaxed. Capital gains and dividends taxed at special low rates make up almost a third of total reported investment income. Tax-exempt interest, if taxable, would increase reported investment income by 4.5 percent.

[1] These figures (and our findings) include the full payroll tax, including the half nominally paid by employers, based on the almost universally accepted belief that the employer tax is passed on to workers. This treatment is consistent with counting the entire self-employment tax, which is equal to the combined payroll taxes paid directly or indirectly by workers.

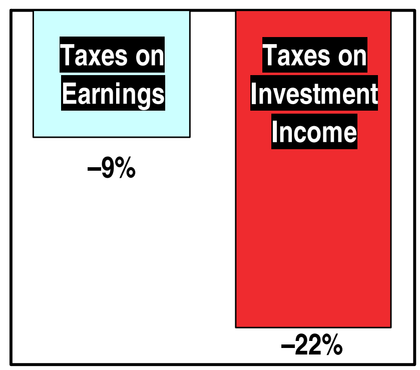
- Third, while almost all earnings are reported on income tax returns (due to wage withholding), a large share of investment income is not reported. This under-reporting reflects not only legislated tax breaks, for real-estate income, business profits, and so forth, but also tax evasion. We estimate that a quarter of total investment income is not reported on tax returns due to legal and extra-legal under-reporting.[2]

President Bush's role in the low taxation of investment income

The Bush tax cuts explain some, but certainly far from all, of the discrepancy in tax rates on earnings compared to investment income. We find that in 2004:

- The Bush income tax reductions have cut federal taxes on earned income by 9 percent.
- In contrast, the Bush income tax cuts lowered taxes on investment income by 22 percent — two-and-a-half times the tax cut on earnings.

Percent Changes in Taxes on Earnings & Investment Income From the Bush Personal Income Tax Cuts (in 2004)



The much larger tax cut for investment income under the Bush program reflects the fact that in addition to his reductions in overall income tax rates (affecting both earnings and investment income), the President also reduced tax rates even further on capital gains and dividends. The top capital gains rate was reduced from 20 percent to 15 percent. The top tax rate on dividends was also set at 15 percent, down from a 35 percent regular top income tax rate under Bush's program.[3]

Almost half of the Bush income tax reductions on investment income in 2004 go to the best-off one percent of all taxpayers — reflecting this group's disproportionate share of total investment income.

Shares of the Total Bush Income Tax Cuts By Income Group & Income Type in 2004

Income group	Earnings	Investment income
Lowest 20%	1.1%	0.4%
Second 20%	6.5%	2.1%
Middle 20%	11.8%	3.6%
Fourth 20%	19.3%	9.6%
Next 10%	17.7%	10.1%
Next 5%	13.3%	8.2%
Next 4%	13.7%	17.3%
Top 1%	16.6%	48.6%
ALL	100.0%	100.0%

Note, however, that even without the Bush tax cuts, the overall tax rate on earnings would still be 2.1 times the rate on investment income — compared to 2.5 times as much under the law as it currently stands.

[2] A table at the end of Appendix II details our estimates of unreported investment income.

[3] Prior to Bush's tax cuts, the top personal tax rate was 39.6 percent. For taxpayers in the bottom two tax brackets, the tax rate on capital gains and dividends was lowered to 5 percent, compared to a 10 or 15 percent regular tax rate. The impact of the 5 percent rate is trivial, however, because taxpayers in the lowest brackets have so little capital gains or dividends.

What would it mean to tax investment income like earnings?

Treating investment income like earnings under the income tax and the Social Security and Medicare taxes would have profound effects on both federal revenues and fairness.

- If investment income were fully reported and taxed at regular income tax rates, federal income tax payments in 2004 would increase by $184 billion.
- Subjecting investment income to Social Security and Medicare taxes would add another $154 billion to revenues.[4]
- The total tax change of $338 billion could reduce the expected federal budget deficit in 2004 by about two-thirds.

In terms of effective tax rates on investment income compared to earnings:

- Treating investment income like earnings for both income tax and Social Security and Medicare tax purposes would increase the average tax rate on investment income from its current 9.6 percent to 28 percent.
- Rather than the current situation in which investment income is taxed far less than earnings, it would be taxed a bit more heavily. That is exactly what a progressive tax system would be expected to do given the concentration of investment income at the top of the income scale.[5]

Federal Tax Rates on Earnings vs. Tax Rates on Investment Income in 2004
If investment income was reported and taxed like earnings

	Taxes on wages & other earnings as a % of earnings			Taxes on investment income as a % of investment income		
	Income tax	Soc.Sec. & Med. tax	Total	Income tax	Soc.Sec. & Med. tax	Total
Lowest 20%	–7.7%	14.1%	**6.5%**	0.9%	14.0%	**14.8%**
Second 20%	–1.4%	14.3%	**12.9%**	3.4%	14.1%	**17.5%**
Middle 20%	4.5%	14.4%	**18.9%**	5.6%	14.1%	**19.6%**
Fourth 20%	7.8%	14.5%	**22.3%**	8.0%	14.1%	**22.1%**
Next 10%	9.8%	14.5%	**24.3%**	10.0%	13.9%	**23.9%**
Next 5%	12.5%	13.7%	**26.2%**	13.2%	12.7%	**25.8%**
Next 4%	17.6%	10.6%	**28.3%**	18.0%	9.7%	**27.7%**
Top 1%	28.2%	5.3%	**33.4%**	28.7%	3.8%	**32.4%**
ALL	**11.2%**	**12.7%**	**23.8%**	**18.8%**	**9.1%**	**28.0%**

[4]The average effective self-employment rate on investment income would be lower than the payroll and self-employment rate on earnings because a much larger share of investment income would be subject to only the 2.9 percent Medicare tax, because total earnings and investment income would be above the $87,900 cap on the 12.4 percent Social Security tax. In computing the potential self-employment tax on investment income for married couples, we split investment income evenly between the spouses.

[5]If all investment income were reported on tax returns, taxes on earnings would also increase—by about 2 percent—because some earnings would be taxed in higher brackets. Taxes on Social Security benefits would also go up slightly. The table on this page reflects these potential changes.

Some might think that taxing investment income as heavily as earnings would be a radical change. Consider, however, that from 1971 to 1981, the federal government actually applied a *higher* top income tax rate to most reported investment income than it applied to earnings. In those days, the top personal income tax rate on earnings was 50 percent, while reported investment income, with the exception of capital gains, was taxed at a top rate of 70 percent.[6]

The lower top income tax rate on earnings in the 1970s stemmed from the Tax Reform Act of 1969, which cut the top tax rate on earnings to 50 percent, while leaving the top rate on most investment income at 70 percent and increasing the top tax rate on capital gains from 25 percent to 36.5 percent.[7] The act was signed into law by President Richard M. Nixon on December 30, 1969, and took full effect in 1972. The official congressional explanation of the bill notes:

> "Since the disincentive effect of high tax rates on effort is greatest in the case of earnings, the Congress concluded that . . . it would be most efficient to apply the 50-percent limit to earned income only." [8]

Less dryly put, in 1969 Congress concluded that working was inherently more taxing that investing — and thus that earnings had a valid claim to more favorable income-tax treatment than investment income.

What would it take to tax investment income like earnings?

As noted at the outset of this report, there are some people who strongly support the fact that our tax system taxes earnings much more heavily than investment income. In fact, the stated goal of "flat-tax" and "national sales tax" advocates is to totally eliminate *all* federal taxes on investment income, and to tax only earnings (or outlays).

For those who feel otherwise, however, here's what it would take to tax investment income like earnings:

- First of all, the special tax rates for capital gains, dividends and tax-exempt interest would have to be eliminated.
- Second, various loopholes and tax shelters for investment income such as real estate would have to be closed.
- Third, to crack down on tax evasion, income reporting requirements for investment income would have to be strengthened and IRS enforcement would have

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[6]The top capital gains tax rate in the 1970s was as high as 39.9 percent, although by the end of the decade it had been cut to 28 percent. The current top income tax rate on capital gains is 15 percent.

[7]The 1969 Act also closed numerous loopholes, cracked down on tax shelters and reduced taxes for middle and low-income workers.

[8]Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969*, Dec. 3, 1970, p. 225. As a transitional measure, the top rate on earnings was reduced to 60 percent in 1971, before falling to 50 percent in 1972.

to be beefed up substantially. For example, under current law, stockbrokers do not report their customers' capital gains to the IRS (except in the case of mutual funds), even though they have the information readily available to do so. Requiring such disclosure could sharply reduce capital gains tax evasion.

- Finally, investment income would have to be subject to Social Security and Medicare taxes just as earnings are.

In total dollar terms, getting rid of special income tax breaks for investment income and dramatically improving compliance would essentially be the equivalent of eliminating the Bush 2004 cuts in personal income taxes. The vast majority of taxpayers, however, would keep most of their Bush tax cuts — in fact, the bottom 95 percent of taxpayers, on average, would keep two-thirds of their cuts. Only the best-off one percent would pay substantially more in personal income taxes than they paid before the Bush tax reductions.[9]

Subjecting investment income to the Social Security and Medicare taxes would also be a progressive change, with almost half the increased taxes falling on the best-off tenth of all taxpayers. In addition, this change would go a long way toward insuring the long-term viability of Social Security and Medicare.

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[9] Top earners would continue to enjoy very substantial tax breaks from the phase-out of the estate tax and the Bush corporate tax cuts.

APPENDIX I

Total Income by Income Group & Type of Income in 2004

Income Group	Total Income, $-billions				Shares of Each Group's Total Income				Distribution by Income Type			Averages		
	Earned	Investment	Transfers	Total	Earned	Investment	Transfers	Total	Earned	Investment	Transfers	Earned	Investment	Transfers
Lowest 20%	$ 151.7	$ 27.7	$ 101.5	**$ 281.0**	54.0%	9.9%	36.1%	**100.0%**	2.8%	1.6%	16.9%	$ 5,640	$ 1,030	$ 3,770
Second 20%	372.3	63.6	135.7	**571.5**	65.1%	11.1%	23.7%	**100.0%**	6.8%	3.8%	22.6%	13,840	2,360	5,050
Middle 20%	697.1	94.5	139.9	**931.5**	74.8%	10.1%	15.0%	**100.0%**	12.7%	5.6%	23.3%	25,910	3,510	5,200
Fourth 20%	1,206.3	196.1	121.8	**1,524.2**	79.1%	12.9%	8.0%	**100.0%**	21.9%	11.6%	20.2%	44,840	7,290	4,520
Next 10%	938.1	168.0	52.5	**1,158.6**	81.0%	14.5%	4.5%	**100.0%**	17.1%	9.9%	8.7%	69,730	12,490	3,910
Next 5%	656.2	133.1	23.9	**813.2**	80.7%	16.4%	2.9%	**100.0%**	11.9%	7.9%	4.0%	97,490	19,780	3,550
Next 4%	797.0	288.4	20.5	**1,105.9**	72.1%	26.1%	1.9%	**100.0%**	14.5%	17.0%	3.4%	148,120	53,610	3,800
Top 1%	681.0	729.0	5.6	**1,415.6**	48.1%	51.5%	0.4%	**100.0%**	12.4%	43.1%	0.9%	506,000	541,730	4,190
ALL	**$ 5,500.2**	**$ 1,691.8**	**$ 601.6**	**$ 7,793.6**	**70.6%**	**21.7%**	**7.7%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**$ 40,310**	**$ 12,400**	**$ 4,410**

Total income is tax return total income, adjusted for underreporting and disregarding most tax "losses," less state tax refunds and alimony paid, plus tax-exempt interest, untaxed Social Security benefits and other cash income not fully reported on tax returns.

Earned income includes wages, business earned income, 30% of pension & IRA income, and unemployment and worker's comp benefits.

Investment income includes interest, dividends, capital gains, 70% of pension and IRA income, and other investment income.

Transfers include Social Security benefits, welfare, SSI, veterans benefits, alimony and child support, and other transfers.

APPENDIX II: METHODOLOGY

This study looks at federal personal taxes, i.e., personal income taxes and Social Security and Medicare taxes, as they apply to personal earnings and investment income.

All of the figures in this study were calculated using the ITEP Tax Model, a large microsimulation model based on the IRS's latest 186,000-record Public Use File (1999) for filers, supplemented by Census data for non-filers. All data are aged to 2004 levels. A full description of the ITEP Tax Model can be found at www.itepnet.org.

In calculating income taxes on reported earnings versus investment income, we could not simply exclude one of the two categories of income from a model run to get taxes on the other category. That's because of graduated tax rates. Without inclusion of earnings in the tax base, investment income would be taxed much more lightly than it is now. Likewise, without inclusion of investment income, earnings would be taxed more lightly than it is now.

So instead, we used the following approach:

I. To compute taxes on earnings, investment income and transfers:

A. Adjusted tax-return total income. We started with tax-return total income (line 22 of the 2003 form), and made the following small adjustments: We subtracted state tax refunds and alimony paid, and we did not subtract (i.e., we added back) tax losses that were reported but not used because they reduced tax-return total income to less than zero on particular returns.

B. Categorizing reported income among earnings, investment income and transfers.

1. Earnings. As reported on tax returns, earnings include: wages; self-employment income from Schedule C (sole proprietorships), Schedule F (farm income) and Schedule E (the portion of partnership income reported as self-employment income); 30 percent of pension and IRA distributions; and unemployment compensation.

2. Investment income. As reported on tax returns, this includes: taxable interest; dividends; realized capital gains and losses; other gains and losses; Schedule E net investment income, i.e., rents, royalties, Subchapter S corporation profits, partnership profits (excluding the earned portion), and net income from estates and trusts; 70 percent of pension and IRA distributions; and net other income. Reported but unused tax losses were excluded. (Note that our figures do *not* include unrealized capital gains or other accrued but unrealized investment income.)

3. Transfers. For tax purposes, this is almost entirely taxable Social Security benefits. It also includes a very small amount for net alimony received less alimony payments deducted.

C. Calculating income taxes on earnings, investment income and transfers.

1. Personal income tax (including the alternative minimum tax) before credits.

a. First we computed personal income tax before credits, with no special tax rates on capital gains and dividends. We assigned this calculated tax to earnings, investment income and transfers based on each type of income's share of adjusted tax-return total income, by income group.

b. Next we calculated the tax savings from the special tax rates on capital gains and dividends. We subtracted this from the preliminary income tax before credits on investment income previously computed.

2. Tax credits. We assigned the earned-income tax credit, the dependent care credit and almost all of the per-child tax credit as reductions in taxes on earnings. We assigned the alternative-minimum-tax credit to taxes on earnings, investment income and transfers according to each type of income's share of adjusted tax-return total income. We assigned other tax credits (foreign tax credit, etc.) to taxes on investment income. (Note: overall, 83 percent of total tax credits were assigned to reduce taxes on earnings.)

3. Income taxes after credits by income type. We subtracted tax credits by income type from personal income taxes before credits by income type.

D. Calculating Social Security and Medicare taxes on earnings (FICA/SECA taxes). This computation included self-employment taxes (12.4 percent for Social Security, capped at $87,900 in 2004) and 2.9 percent for Medicare, uncapped) and payroll taxes on wages at the same rates (including the portion of the payroll tax nominally paid by employers). All of these taxes on earnings were assigned to earnings.

E. Total federal personal taxes by income type. We combined income taxes and Social Security and Medicare taxes by income type.

II. To compute <u>total</u> earnings, investment income and transfers:

A. Augmenting reported income by income that is not required to be reported on tax returns or that goes unreported despite legal requirements. This adjustments include:

- Include tax-exempt interest.
- Increase capital gains by estimated unreported gains.
- Increase business earned income (sole proprietorships, farm and partnership) by estimated unreported profits, and decrease losses by estimated over-reported losses.
- Increase other reported investment income by estimated unreported profits and decrease losses by estimated over-reported losses.
- Include transfers not required to be reported on tax returns (welfare, workers' compensation, etc.).
- *Note:* our figures do not include non-cash earnings (e.g., employer-paid health insurance), nor do they include accrued but unrealized investment earnings (such as unrealized capital gains, inside build-up in untaxed investment accounts, etc.)

B. Assigning these income augmentations. We assigned these changes to earnings, investment income and transfers using rules similar to those used for reported income. (See page 6 for a full list of the differences between reported and total income. See page 7 for the full results for total income.)

III. To compute effective tax rates on earnings, investment income and transfers.

We divided total personal taxes by income type by total income by income type.

Note: A table showing the differences between income reported on tax returns and estimated actual income follows.

Differences between Reported Income and Actual Income in 2004 ($-billions)

DETAILS OF DIFFERENCES	Reported Income	Actual Income	Difference	% of total difference	% difference
Adjustments to income:					
Tax-exempt interest	$ —	$ 57.0	$ +57.0	5.5%	nm
Capital gains (positive)	317.6	471.1	+153.4	14.8%	+48%
Sole proprietor & farm income	307.3	372.0	+64.6	6.3%	+21%
Schedule E income (positive)	410.4	531.9	+121.5	11.8%	+30%
Social Security benefits	105.9	455.2	+349.3	33.8%	+330%
Other transfers	—	154.7	+154.7	15.0%	nm
All other (no change)	5,807.5	5,807.5	—	—	—
Total positive items	**$ 6,948.8**	**$ 7,849.4**	**$ +900.6**	**87.2%**	**+13%**
Adjustments to "losses":					
Capital losses	$ –11.1	$ —	$ +11.1	1.1%	–100%
Sole proprietor & farm losses	–51.4	–22.1	+29.2	2.8%	–57%
E & other losses (net used)	–123.9	–31.5	+92.4	8.9%	–75%
All other (no change)	–2.1	–2.1	—	—	—
Total negative items	**$ –188.4**	**$ –55.7**	**$ +132.7**	**12.8%**	**–70%**
TOTAL ALL	**$ 6,760.4**	**$ 7,793.7**	**$ +1,033.3**	**100.0%**	**+15%**

DIFFERENCES BY INCOME GROUP	Reported Income	Actual Income	Difference	% of total difference	% difference
Lowest 20%	$ 172.2	$ 281.0	$ +108.7	10.5%	+63%
Second 20%	423.3	571.5	+148.2	14.3%	+35%
Middle 20%	770.9	931.5	+160.7	15.6%	+21%
Fourth 20%	1,390.0	1,524.2	+134.3	13.0%	+10%
Next 10%	1,088.3	1,158.6	+70.3	6.8%	+6%
Next 5%	758.0	813.2	+55.3	5.3%	+7%
Next 4%	995.8	1,105.9	+110.1	10.7%	+11%
Top 1%	1,161.7	1,415.6	+254.0	24.6%	+22%
ALL	**$ 6,760.4**	**$ 7,793.6**	**$ +1,033.2**	**100.0%**	**+15%**

DIFFERENCES BY INCOME TYPE	Reported Income	Actual Income	Difference	% of total difference	Reported / Actual
Earned income	$ 5,379.7	$ 5,500.2	$ +120.5	11.7%	98%
Investment income	1,273.0	1,691.8	+418.8	40.5%	75%
Transfers	107.7	601.6	+493.9	47.8%	18%
TOTAL	**$ 6,760.4**	**$ 7,793.7**	**$ +1,033.3**	**100.0%**	**87%**

Reported income is tax return total income, less state refunds, less alimony paid, and without unused tax losses. Estimated actual cash income differs from reported income as detailed.