Income Data and The Future of the Nation

By David Cay Johnston

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The latest income data tell an important story about tax policy and the future of our nation, a story with parallels in the fate of a majestic rock on the California beach where I grew up.

The data story is about how, over time, policy subtly shapes our lives through small, almost unnoticeable changes, just as shifting sands and flowing water slowly work on a geologic time scale that makes rock formation seem timeless until the status quo abruptly and dramatically changes.

On the surface, the income numbers indicate that the economic lives of Americans are improving.

Tax returns show that in 2006, for the third year in a row, Americans reported rising average and total income. Census Bureau estimates for 2007 show that the median income — half make more, half make less — was $50,233, up 1.3 percent in real terms over 2006. Mark Zandi, the chief economist at Moody's Economy.com, told *The Christian Science Monitor* that "it's a good solid report," and the newspaper agreed, its story characterizing 2007 as "a good solid year." But look just a little deeper and a different picture emerges, one of economic erosion.

While median income rose year-over-year in 2007, it was still smaller than way back in 1999 by $408 or nearly 1 percent. Eight years and no gain is not good news.

My analysis of the latest reports from the IRS Statistics of Income Division showed that in 2006, taxpayers reported higher average income for the first time since 2000. But the gain was just $740, from $57,289 in 2000 to $58,029 in 2006.

Average income fell sharply in 2001 and 2002, the result of the Internet bubble popping and the shocks from Osama bin Laden's murderous rampage. Average incomes grew a tad in 2003, and then rose sharply, growing by about $2,300 in 2004, by $2,200 in 2005, and then at a much slower pace in 2006, up less than $1,400.

Looking deeper, the data show that the gains are almost all at the top. Among people making less than $75,000 — roughly 8 of every 10 taxpayers — 2006 average incomes remained below those of 2000 levels. And of the gains of the top fifth, an astonishing 42 percent went to the 1 in 400 taxpayers who reported seven figures or more of adjusted gross income on their Form 1040.

But the important story is in wages. For the 99.75 percent of Americans making less than $1 million, wages were up, but by so little that it would be hard to notice. Average wages in 2006 were just $170 more than in 2000.

Among those making more than $1 million, it was a very different and more complicated story. First, their numbers grew by 42.9 percent, to $285,759. But their total wages fell and so did the average.

How can the number of million-dollar-plus incomes soar and the total income of that group fall? It happened because the 33,000 taxpayers who made more than $5 million in 2006 had much smaller wages than in 2000 — on average, $2 million less. That shows just how concentrated the stock option gains in the Internet bubble were in 2000.

But on a larger scale, wages are declining as a source of income in America. The portion of Americans earning wages is slipping, and the share of total income from wages is dropping. The tax data show that in 2006, 84 percent of Americans reported earning wages, down from 85 percent in 2000, or more than a million taxpayers.

The share of adjusted gross income due to wages was 82 percent in 1980. By 2000 it was down to 70 percent, and in 2006 it slipped to 68 percent of all income.

So where is the income growth coming from? A small part is from pensions and retirement savings plans, which are simply deferred wages, and which will continue to grow as the boomers move into their final decades. But the big growth in incomes is in business profits and investment gains.

And therein lies the big story. The dominant and often only form of income for most Americans is slowly eroding, while the capital incomes earned by those at the top are soaring.

It was these figures that made me think of the unusual rock that was formed 3 million or more years ago in Santa Cruz, Calif., and for as long as history records stood on the beach near the mouth of the San Lorenzo River. It looked like a 40-foot sandstone dagger thrust point-down into the earth. Its large square top was supported by a narrow base. As a boy I played with pals in the winter waves that, like wet sandpaper, slowly wore away the base, and marveled at how such a narrow base continued to support such a large top.

My question was answered in 1989, when the Loma Prieta earthquake, striking just as the transbay World Series began, split the rock and two large pieces toppled. Now sand covers them, and only a stub of the seastack remains visible.

Wages are the base of the American economy, crucial not just to consumption, but to political stability. And our policies are slowly eroding that base. We have eroded wages through laws that have weakened unions, unlike our competitors in Europe, where even managers are often in unions. Other policies favor moving capital offshore; in this area, *Tax Notes* contributing editor Martin Sullivan has shown that profits are, at least under the accounting rules, very high.

Meanwhile, through favors for individual businesses and sometimes whole industries, our federal and state governments exclude ever more business and investment income from tax.

And while it is true that the top 10 percent pay the lion's share of income taxes, this levy explains only about a sixth of the dollars that governments at all levels collect. When you look at all federal taxes that fall directly on individuals, the data show that schoolteachers, cops, and office workers pay marginal tax rates of more than 40 percent on wages that have been mostly stagnant over the past three decades. But at the very top, where the marginal tax rate is just 15 percent, incomes soar.

Wages are shrinking in significance in our economy. Tax policy is going to be crucial here. Without a growing stream of money from wages, people will not have money to spend and that will, over time, diminish the value of the capital in the United States.

When we get the data for 2008, it's likely that it will show continued weakness in incomes and wages, with a likely drop in median and average incomes. Indeed, the economic woes today are so widespread that *Barron's*, the weekly bible of those who worship in the House of Mammon that is Wall Street, reported on July 28 that ''the rich are suffering, too.'' It also reported that East Hampton, a summer escape for the richest New Yorkers, said its municipal bank account fell to $900 earlier this year, largely because mortgage tax revenues have collapsed along with the housing market.

American Express, the plastic of choice for upscale Americans, reported that people were charging less and paying less back, too. Overdue accounts rose by a third to 3.9 percent, said the company, whose shares have fallen about 40 percent in the past year. That decline is more than twice as much as the overall market for big-company stocks.

The aughts are turning out to be our lost decade, economic doldrums unrelieved by the Bush administration's tax cuts, its undeclared Keynesian spending, or even its propensity for war expenditures, which has lifted economies in the past.

Presidents do not deserve all that much credit for economic strengths and weaknesses. Still, it is notable that tax return data show that during the first six years of the Clinton administration, average incomes, adjusted for inflation, grew 16.2 percent, by $7,665 to $54,875 in 1998. That is more than 10 times the average income growth from 2000 to 2006, the first six years of the Bush administration.

The average income in 1998 was exceeded only twice during the first six years of the Bush administration, in 2005 and 2006.

During the first six years of the Reagan administration, average incomes declined, falling $1,640 to $46,362 in 2006 dollars, income tax data show.

We need policies that focus on wages if we want broad prosperity. We need to look at the world the way employers do, who see the payroll tax as a good reason to shed workers and hire people on contract and, when they can, shift jobs overseas.

These changes will not take place in a day or even during one administration. But unless we start to build the base, one day we will find that our society, like that rock on the beach in Santa Cruz that stood for eons, may abruptly split open, with far worse consequences than tons of ancient sandstone falling on a beach.

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The chart with my previous column, on the mortgage interest deduction, suffered from a misplaced decimal, rendering some numbers as a tenth of the correct figure. The error does not affect the point of the column. For those making $30,000 to $40,000 the total amount deducted for home mortgage interest was $27.78 billion and the estimated savings for that income level per taxpayer and per taxpayer who took the deduction should have been $294 and $1,258, respectively.

Your thoughts? E-mail me at *JohnstonsTake@tax.org.*