

The Fortunate 400

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This June, the Statistics of Income (SOI) Division of the Internal Revenue Service released selected tax return information for 1992-2000 concerning the 400 taxpayers with the highest adjusted gross income (AGI) in each year.¹ This follows an earlier analysis based on unpublished SOI data for 1992-1998 that included less comprehensive data for those years from the top 400 returns ranked by AGI as well as by taxable income and tax liability.² A front-page article in the *New York Times* discussed this new data release, prompting a reply from Jim Sexton, chairman of the Joint Economic Committee (JEC), that characterized the data as “meaningless” and “misleading” because of the year-to-year fluidity of the identity of the 400.³ This article reviews and evaluates these data, with the objective of clarifying what can and cannot be learned from this kind of information.

Snapshots

According to the data release, in 2000 the top 400 received \$69.6 billion in AGI, which is 1.09 percent of total AGI, although they comprised just 0.00031 percent of the total number of individual tax returns.⁴ To make it into the top 400, one needed an AGI of \$86.8 million, and the average AGI of the group amounted to \$173.9 million. By far the largest income source was realized capital gains, which is notable because capital gains realizations represent income that has accrued over a number of years, and not just in the year of realization, and thus are not readily comparable to other components of AGI.⁵ In 2000 capital gains of the Fortunate 400 accounted for 71.83 percent of their AGI. Salaries and wages comprised 16.70 percent, taxable interest comprised 3.93 percent, partnership and S corporation income 3.19 percent, dividends 2.77 percent, and

business and profession net income less loss made up only 0.60 percent of total AGI. The net capital gains in AGI of these 400 taxpayers—averaging \$124.9 million—amounted to 8.13 percent of the total for all taxpayers.

The Fortunate 400 paid \$15.5 billion in income tax for 2000, which amounts to 1.58 percent of the total tax. That the percentage of total tax paid by this group exceeds their percentage of total AGI implies that their average tax rate—defined as tax divided by AGI—is higher than for the population as whole. Indeed, the average tax rate of the top 400 in 2000 was 22.29 percent, compared to 15.41 percent for the whole taxpayer population.

Trends

As Table 1 illustrates, the snapshot of the Fortunate 400 portrayed by these data changed dramatically between 1995 and 2000. In 1995 their share of total AGI was 0.49 percent, so between 1995 and 2000 it more than doubled, to 1.09 percent in 2000.⁶ The biggest factor in this development was the growth in capital gains. In 1995 the top 400 had \$9.0 billion of net capital gains in AGI, while by 2000 this figure had grown to \$50.0 billion, an increase of \$41.0 billion. Aggregate capital gains rose even more over this period, as total net capital gains in AGI rose from \$166.8 billion in 1995 to \$614.7 billion in 2000. But the percentage increase in capital gains was much higher for the Fortunate 400.

Beginning in 1995 there was also a notable decline in the average tax rate faced by the top 400. This rate fell from 29.93 percent in 1995 to 22.29 percent in 2000. Over the same period the average tax rate for all taxpayers *rose* from 14.05 percent to 15.51 percent. Thus, the ratio of the average tax rate on the Fortunate 400 to the whole taxpaying population fell from 2.13 in 1995 to 1.45 in 2000. The changing importance and taxation of capital gains explains most of the drop in the average tax rate of the top 400. As the composition of their AGI shifted toward preferentially taxed capital gains, the average tax rate fell. In addition, in 1997 the top rate on capital gains was changed from 28 percent to 20 percent.

Table 1: AGI, Capital Gains, and Tax of the Fortunate 400, 1995 and 2000

	1995	2000
AGI of Fortunate 400 (\$billions)	20.4	69.6
Total AGI (\$billions)	4189.4	6365.4
Percent of total AGI	0.49	1.09
Net capital gains in AGI of Fortunate 400 (\$billions)	9.0	50.0
Total net capital gains in AGI (\$billions)	166.8	614.7
Percent of total net capital gains in AGI	5.38	81.3
Income tax of Fortunate 400 (\$billions)	6.1	15.5
Total income tax (\$billions)	588.4	980.6
Percent of total income tax	1.03	1.58
Average tax rate of Fortunate 400	29.93	22.29
Average tax rate of all taxpayers	14.05	15.41
Ratio of Fortunate 400 tax rate to tax rate of all taxpayers	2.13	1.45

Source: IRS (2003) and author's calculations.

The Top 1 Percent

Some of the same characteristics and trends are also evident if the top group is defined not as the top 400 taxpayers, but instead as the top 1 percent of all taxpayers. A separate data release from the IRS⁷ shows that in 2000 the top 1 percent of taxpayers—a group which numbers 1,282,271—arranged by AGI received 20.61 percent of total AGI, and paid 37.42 percent of total income tax.⁸ In 1995 their AGI share was 14.60 percent, and their tax share was 30.26 percent. The average tax rate of the top 1 percent declined much less sharply over this period compared to the top 400, dropping from 28.73 percent in 1995 to 27.45 percent in 2000.⁹ For all taxpayers over this period there was an increase in the average tax rate from 13.86 percent to 15.26 percent, so that the ratio of average tax rates fell from 2.07 to 1.80. Thus, the same trends appear for the top 1 percent as for the Fortunate 400, but in a less striking way, largely due to the lower relative significance of capital gains for the top 1 percent compared to their significance for the Fortunate 400. The relative importance of capital gains for the Fortunate 400 is also an important reason why the average tax rate of the Fortunate 400 in 2000 was actually below—22.29 percent versus 27.45 percent—that of the top 1 percent group.

The increased concentration of income since 1995 is part of a longer trend that began around 1980. Piketty and Saez (2001) show that the share of income excluding

capital gains received by the top 0.01 percent of taxpayers, a much larger group than the top 400, increased from 0.65 percent in 1980 to 1.80 percent in 1995, and then jumped sharply from 1.80 percent to 3.06 percent in 2000. This increase of more than two-thirds in five years is somewhat less than the more than doubling of the share of the Fortunate 400 over this period. Significantly, the Piketty-Saez measure of income excludes realized capital gains, showing that the increased concentration at the top is by no means solely the result of the extraordinary increase of capital gains realizations over this period.

Why Snapshots May Mislead

Under some circumstances a 1-year snapshot of the distribution of some measure of income can give a misleading picture of the distribution of a more permanent notion of income or economic well-being. As an extreme illustration, consider an economy of individuals who are identical except for age, where each individual follows the same life-cycle pattern of increasing income over the working years, followed by a period of retirement with no labor income. A 1-year snapshot of the distribution of income would reveal a skewed income distribution, with the relatively poor being young and retired, even though lifetime income is the same for everyone.

Snapshots may also give a misleading picture of the distribution of income *sources* in the presence of transitory income. Another extreme example illustrates. Imagine that both labor income and capital gains realizations are equally distributed over a lifetime, but labor income is constant from year to year while capital gains vary a lot. In this case a snapshot of any year's distribution of income sources will reveal that the distribution of total income is more unequal than that of labor income alone and capital gains are a more important source of income for high-income individuals. These facts will appear even though, over the long run, capital gains realizations are distributed no differently than labor income and all individuals have equal income.

In addition to life-cycle changes in income and transitory income, there are certainly real changes in people's economic prospects. Through hard work and luck, some improve their position, and others' positions decline. Because of the presence of transitory income, these data do not allow one to assess either the degree of real income

mobility or whether a permanent measure of income has gotten more unequal over this period.

These examples illustrate how, in theory, snapshots can be misleading about the distribution of income. They do not necessarily imply that statements based on snapshots about *tax progressivity* will be misleading. But that is possible. For example, if those taxpayers who are at the top of the income distribution are there because of transitory capital gains realizations, and capital gains are preferentially taxed, it will look like the average tax rate of the most fortunate is lower than others in the top tax bracket who do not have as much of their income in capital gains.

Prior research suggests that these concerns about snapshots are probably not a large practical issue. Based on data from 1979 to 1985, I found in Slemrod (1992) that inequality based on a 7-year average of income was not significantly lower than the inequality in a 1-year snapshot, although the fraction of income received by the *lowest* decile did increase substantially in the 7-year average. The 7-year average did somewhat reduce the contribution to inequality of capital gains, although with either calculation capital gains are a very important component of the income of the highest-income taxpayers. While in any given year, on average capital gains comprised 51.8 percent of the income of the top 1 percent, this figure was 43.7 percent for the 7-year average. The message is that capital gains are a disproportionate fraction of the income of the affluent, although not quite as large as a 1-year snapshot would suggest. This is consistent with other evidence that shows that in any given year most capital gains are realized by taxpayers who regularly have realizations.¹⁰

Mobility

The text accompanying the IRS data release mentioned that the top 400 “represent a changing group of taxpayers over time, rather than a fixed group of taxpayers.” In support of this, the text notes that, of the taxpayers who appear in the group of 3,600 returns (400 per year for each year between 1992 and 2000), less than 25 percent appear more than once, and less than 13 percent appear more than twice.¹¹ The July 2, 2003 JEC press release expanded on this and showed that 2,218 different primary filers appeared at least once in the top 400 over this period. As Table 2 shows, of this amount 1,679, or

75.7 percent of the 2,218, appeared in just one of the nine years. However, 539, or 24.3 percent of the total, appeared in more than one year and 99, or 4.4 percent, appeared in at least six of the nine years. Of the 3,600 tax returns that made the top 400 between 1992 and 2000, 1,921, or 53.4 percent, were filed by a taxpayer that made the top 400 more than once over this period; the 21 returns that were included in all nine years by themselves accounted for over 5 percent of the total.¹²

Table 2: Persistence of Fortunate 400 Taxpayers, 1992-2000

Number of Occurrences in Top 400 over 9 Years	Number of Returns in Each Group	Percent of Returns Represented by Each Group	Number of Participants in Total Top 400 Population over 9-year Period	Percent of Participants Represented by Each Group
1	1,679	75.70%	1,679	46.64%
2	252	11.36%	504	14.00%
3	94	4.24%	282	7.83%
4	52	2.34%	208	5.78%
5	42	1.89%	210	5.83%
6	36	1.62%	216	6.00%
7	24	1.08%	168	4.67%
8	18	0.81%	144	4.00%
9	21	0.95%	189	5.25%
Total	2,218	100.00%	3,600	100.00%

Source: Joint Economic Committee (2003) and author's calculations.

In these calculations the extent of real changes in economic position is exacerbated by the importance of capital gains realizations. Just as a capital gain realization does not indicate that real income in that year was particularly high, the fact that someone realizes a capital gain in one year and not the next says little or nothing about a change in real economic circumstances. Second, the more finely one defines the “top,” the less meaningful this measure of transience becomes. Consider the transience of the top 1 percent. In a typical year in the first half of the 1980s, two-thirds of taxpayers in the top 1 percent were in the top 1 percent the previous year.¹³

The transience of the Fortunate 400 should not be taken to suggest that there is a high likelihood that an average American will reach this plateau or anywhere close to it. Indeed, Bradbury and Katz (2002) show that in the decade from 1988 to 1998, only 4.3 percent of the families in the lowest two income quintiles at the beginning of the decade

made it to the highest *quintile* 10 years later, much less to the top 1 percent or the Fortunate 400.¹⁴

Summary

What conclusions can be drawn from the data about the Fortunate 400?¹⁵

- A tax-return-based measure of income, adjusted gross income, is highly concentrated. A group that in 2000 represented less than 1 out of every 300,000 taxpayers received over 1 percent of total AGI.
- The share of total adjusted gross income received by this group more than doubled between 1995 and 2000.
- Realized capital gains are by far the largest component of the adjusted gross income of the Fortunate 400, and the fivefold increase in capital gains received by this group is a large factor in their increased share of adjusted gross income between 1995 and 2000.
- The average tax rate on the Fortunate 400 declined by more than 7 percentage points between 1995 and 2000, at the same time the average tax rate for all taxpayers increased. The decline was primarily due to the preferential rate on capital gains, which applied to a growing fraction of the adjusted gross income of the Fortunate 400, and which fell in 1997.

What, if anything, does this set of data tell us about tax policy and, in particular, tax progressivity? It adds one more piece of corroborating evidence that the increase in income inequality that began about 1980 dramatically accelerated about 1995. Standard models of optimal progressivity suggest that the greater the inequality in pre-tax income, the greater the appropriate degree of progressivity of tax-and-transfer system.¹⁶ These models do not, alas, tell us much about what that appropriate degree of progressivity is, and therefore where we now stand relative to what is appropriate. It also reminds us of the importance of the preferential tax treatment of capital gains—and, now, dividends—in determining how much progressivity is achieved.

Looking Ahead

The concentration of adjusted gross income probably peaked in 2000. Certainly the stock market peaked early in that year. Preliminary data shows that total net capital gains fell from \$588 billion in 2000 to \$326 billion in 2001.¹⁷ Because of the concentration of realized capital gains as well as gains from the exercise of stock options (which are taxed as ordinary income¹⁸ and counted as wages and salaries in these data), this will probably reduce the concentration of AGI.

Because of the timing of the stock market decline, I expect that the share of total income received by the Fortunate 400 in 2001 (and 2002 and probably 2003) will be below their share in 2000. The likely drop in the share of their income that is preferentially-taxed capital gains will cause the average tax rate of this group to increase. However, the tax changes in 2001 and 2003 will offset, and possibly outweigh, this increase, as both reduced the top tax rate (and other tax rates). Of particular relevance is the feature of the 2003 law that reduced to 15 percent the maximum tax rate that applies to dividends and to long-term capital gains occurring on or after May 6, 2003. Because both dividends and especially capital gains are disproportionately received by the affluent, this feature of the 2003 tax law will tend to reduce the average tax rate of the Fortunate 400, both in absolute terms and relative to all taxpayers.

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¹ The IRS data was prepared under the direction of Michael Parisi and Michael Strudler of the Statistics of Income Division of the IRS. It can be accessed at <http://www.irs.gov/pub/irs-soi/00in400h.pdf>, and is also published in Internal Revenue Service (2003).

² Slemrod (2001) and JEC (2003).

³ Johnston (2003).

⁴ Net worth is even more concentrated than AGI. According to the Forbes 400 list of the richest 400 Americans, in 2000 their net worth totaled \$1.19 trillion. According to Aizcorbe, Kennickell, and Moore (2003, Table 3 and p. 30), in 2001 mean family net worth according to the Survey of Consumer Finances (SCF) was \$395,500. Multiplying by 106.5 million families yields \$42.1 trillion. Assuming that aggregate net worth in 2000 was about the same as in 2001, in 2000 the richest 400 Americans accounted for about 2.8 percent of total net worth. This is a slight overestimate because the SCF estimate of aggregate net worth specifically excludes individuals on the Forbes list, so that the denominator is a bit too low.

⁵ Note that adjusted gross income does not accord with economic income. It excludes some items in economic income such as accrued but not realized capital gains and interest from state and local bonds, includes some items not in economic income such as realized capital gains, and mismeasures most kinds of capital income in the presence of inflation. Depending on the relative importance of these issues at different levels of true income, the concentration of income and the average tax rates will be mismeasured. The average tax rates also do not include non-income taxes or non-federal taxes of any kind.

⁶ The share of net worth held by the richest 400 was also increasing over this period. According to Kennickell (2003), the share of net worth held by those on the Forbes 400 list of the richest Americans was 1.7 percent in 1995. In footnote 5 I calculate it to be 2.8 percent by 2000. Kennickell has it falling back to 2.3 percent in 2001, due to the 22.7 percent drop in the real net worth of the Forbes 400 between 2000 and 2001.

⁷ This data is discussed in a press release from the Joint Economic Committee released on October 24, 2002 that can be accessed at <http://www.house.gov/jec/press/2002/10-24-02.htm>. It is somewhat ironic that the same Joint Economic Committee that labeled the top 400 data as “meaningless” and “misleading” requested the top 1 percent data, and in its accompanying press release characterized this data, which uses almost exactly the same methodology as the top 400 report, as “provid[ing] the necessary context in which to evaluate claims about the supposed distributional impact of various tax policy proposals.” To be fair, this remark referred to the 37.42 percent share of total income taxes paid by the top 1 percent group.

⁸ There is a slight difference in methodology in the two reports that leads to slightly different results. The top 1 percent report includes only returns with positive adjusted gross income, while the top 400 report does not exclude returns that do not have positive AGI.

⁹ The average tax rate of the top 1 percent was 33.13 percent in 1986, the first year this report covers. The overall average tax rate in 1986 was 14.54 percent, so the ratio of the average tax rate of the top 1 percent compared to the average tax rate for all taxpayers was 2.28. In 1986 the share of AGI of the top 1 percent was 11.30 percent, and their share of income tax was 25.75 percent. Note that the top 1 percent group contains an increasing number of taxpayers, growing from 1,020,876 in 1986 to 1,282,271 in 2000. In contrast, the size of the Fortunate 400 does not change. This methodological difference would make the share of the Fortunate 400 appear to be growing more slowly than the share of the top 1 percent.

¹⁰ See Slemrod, Kalambokidis, and Shobe (1989).

¹¹ According to Kennickell (2003), there is a lot more persistence among the Forbes 400 list of the richest Americans. His Table 3 shows that, of the 400 in the 2001 list, 190 were also in the 1992 list.

¹² Note also that the matching of tax returns across year was done by comparing the Social Security number of the primary filer, which in a joint return corresponds to the name listed first on the tax return. This procedure will not produce a match for several reasons that are unrelated to true income mobility, such as the reversal of the order of names of a married couple filing jointly, divorce, or death of a primary filer. I have no way of knowing how important these factors are for these calculations; the more important they are, the more these measures will understate the persistence of very high AGI.

¹³ This calculation is in Slemrod (1992). The income concept used for this calculation was expanded income, which is adjusted gross income plus excluded long-term capital gains, excluded dividends, and all adjustments to income.

¹⁴ The 4.3 percent figure includes the upward movement that arises as a result of higher earnings that come with age and experience.

¹⁵ Why call them the “Fortunate” 400? Mostly because the name brings to mind the Fortune 500 listing of America’s largest public corporations, the Forbes 400 list of the richest Americans, and similar lists. Of course, economic success depends on, *inter alia*, competence and hard work, as well as fortune or luck, including inheritance. The classic study of the relative contribution of these factors is Jencks, et al. (1972); they note that “those who are lucky tend, of course, to impute their success to skill, while those who are inept believe that they are merely unlucky.” (p. 227). Finally, the title nods to the November 20, 2002 editorial of *The Wall Street Journal* that refers to people whose income is so low that they pay little or no income tax as “lucky duckies.” How optimal tax policy toward the rich depends on the relative role in economic success of competence, effort, luck, and tastes is discussed in Slemrod (2000).

¹⁶ The relationship between increasing inequality and progressivity is explored at length in Slemrod and Bakija (2001).

¹⁷ Internal Revenue Service (2002-3).

¹⁸ This statement applies to “non-qualified” options, which comprise the bulk of options.