Economics Group

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Income Growth: The Taxman Cometh

The following report is an update to the previously released report of the same title. Changes to the BLS methodology skewed the after-tax data. These changes and their implications are discussed below.

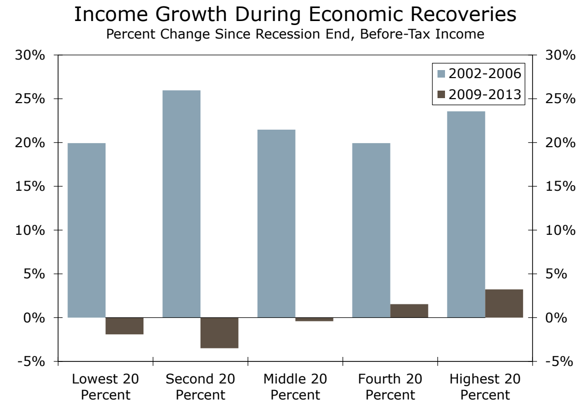
Lackluster Income Growth

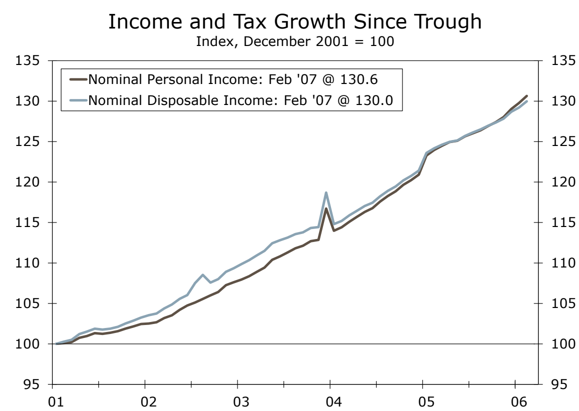
In our previous report, we first discussed the lack of before-tax income growth since the end of the recession. This story remains true, as the data in the top chart have not been affected by the methodology changes implemented by the BLS in 2013, which we discuss later. However, the BLS data tells a slightly different story than the BEA personal income data, which shows income dropping in January 2013 but recovering these losses afterwards (bottom chart). This drop was likely a result of companies ramping up dividend and bonus payments ahead of the tax policy changes on January 1, 2013. Among these changes were the expiration of the Bush-era 2 percent payroll tax cut for all workers, increased capital gains taxes and a tax hike on the highest income earners.

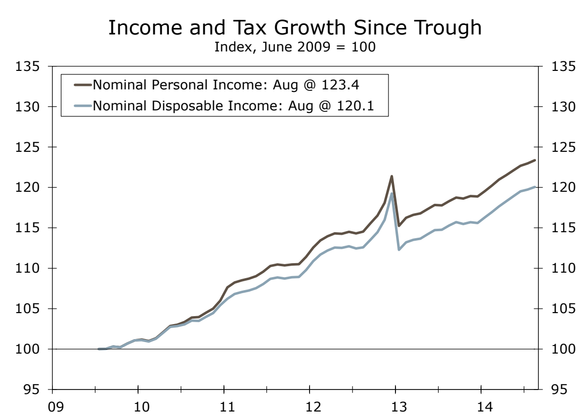
In 2013, the BLS changed their methodology in their consumer expenditure survey (CEX), the source of data for our original report. While in previous years the BLS used survey responses to calculate tax burdens, in 2013 they started using Census tax software to calculate tax burdens more precisely. The previous methodology was subject to large errors because non-responses were recorded as zeroes. This likely underestimated the actual tax burden of respondents. Thus, the new methodology, while more accurate, overestimates the change in after-tax income from 2012 to 2013.

Although the original BLS data we used overestimated the effects of tax policy on income growth, we can use BEA personal income data to compare the tax situation in this cycle to the previous one. In the previous recovery, President Bush enacted broad-based tax cuts, including specific tax cuts for the highest income earners, whose effects can be seen in the middle chart. Nominal disposable income, or nominal personal income less current taxes, increased by roughly the same amount as nominal pre-tax income over the course of the five years following the end of the 2001 recession. Conversely, growth in disposable income in the five years following the most recent recession is lagging roughly 3.5 percentage points behind pre-tax income growth, which itself has been growing slowly relative to the previous cycle.

The divergence in growth between before and after-tax income has been exacerbated since the aforementioned Bush-era tax cuts expired. The effects of the tax policy can clearly be seen in the bottom chart, as before and after-tax income spiked and then sharply declined at the start of 2013. However, disposable income has still grown roughly 10 percent since the end of the recession, contrary to the negative growth our prior data had suggested. Thus, while changes in tax policy seem to indeed have had an impact on the income picture in the United States, it seems as though the data we previously used overestimated the effects of these changes. We unfortunately do not have access to other data on after-tax income by quintile, so we cannot make the same comparisons across income levels that we did in our original report.







Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities, LLC

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