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July 29, 2004

I.R.S. Says Americans' Income Shrank for 2 Consecutive Years

By DAVID CAY JOHNSTON

The overall income Americans reported to the government shrank for two consecutive years after the Internet stock market bubble burst in 2000, the first time that has effectively happened since the modern tax system was introduced during World War II, newly disclosed information from the Internal Revenue Service shows.

The total adjusted gross income on tax returns fell 5.1 percent, to just over $6 trillion in 2002, the most recent year for which data is available, from $6.35 trillion in 2000. Because of population growth, average incomes declined even more, by 5.7 percent.

Adjusted for inflation, the income of all Americans fell 9.2 percent from 2000 to 2002, according to the new I.R.S. data.

While the recession that hit the economy in 2001 in the wake of the market plunge was considered relatively mild, the new information shows that its effect on Americans' incomes, particularly those at the upper end of the spectrum, was much more severe. Earlier government economic statistics provided general evidence that incomes suffered in the first years of the decade, but the full impact of the blow and what groups it fell hardest on were not known until the I.R.S. made available on its Web site the detailed information from tax returns.

The unprecedented back-to-back declines in reported incomes was caused primarily by the combination of the big fall in the stock market and the erosion of jobs and wages in well-paying industries in the early years of the decade.

In the past, overall personal income rose from one year to the next with relentless monotony, the growth rate changing in response to fluctuations in economic activity but almost never falling.

But now, with many more ordinary employees joining high-level executives in having part of their compensation dependent on stock options and bonus plans, a volatile and relatively unpredictable new element has been

introduced to the incomes of millions of workers.

"Risks used to be confined largely to executives and business owners with large incomes," said Edward N. Wolff, an economist at New York University who studies wealth and income.

"But now for many people with more modest incomes their earnings are more volatile," Mr. Wolff added, leaving them more vulnerable to losing pay they count on to meet regular expenses like mortgage payments, car loans and day-to-day living costs.

The new data also helps explain why personal income taxes, the government's most important source of revenue, are subject to much greater fluctuations than in the past. It may help analysts do a better job in predicting changes in government receipts and provide businesses with clues to help anticipate bigger ups-and-downs in spending for their goods and services.

Before the recent drop, the last time reported incomes fell for even one year was in 1953. The only other time since World War II that the I.R.S. reported an interruption in income gains was from 1947 to 1949, but that was because of changes in the tax law at the time that affected how income was reported rather than an actual fall.

From 2000 to 2002, individual income taxes fell 18.8 percent, more than three times the decline in adjusted gross incomes, the I.R.S.'s latest statistical reports show. (Adjusted gross income is the broadest category of income taxpayers report to the government, excluding only a small portion of income in other forms, notably interest on tax-free bonds.)

To some extent, taxes fell more than incomes because of tax cuts championed by President Bush and approved by Congress in 2001. But in that year and in 2002 the cuts applied primarily to those making less than $100,000, especially families with children, and to capital gains from the sales of appreciated assets like stock.

The major tax rate reductions for highly paid Americans did not take effect until 2003, when - it is clear from spending patterns, general income data and the performance of the stock market - more affluent taxpayers regained some of the losses they experienced in the earlier years of the decade.

Falling incomes, rather than tax cuts, appear to count for the greatest share of the decline in income taxes paid. That is because the higher one stood on the income ladder the greater the impact was likely to be from the stock market crunch.

At the same time many of those whose incomes fell the most - those reporting $200,000 to $10 million in income - paid at the highest rates, which meant that the drain on revenues was even greater when their incomes shrank.

More than 352,000 taxpayers, one of every eight who had worked their way above $200,000 of income in 2000, fell below that figure in 2002.

At the very top the ranks thinned by more than half. The number of taxpayers reporting adjusted gross income of $10 million or more fell to 5,280 from 11,215.

The combined income of this rich and thin slice of Americans plummeted 63 percent, to $110 billion, in 2002 from $300 billion in 2000. Among those who stayed in this category average annual income fell 22 percent, to $20.9 million from almost $26.8 million in 2000.

Capital gains income, which results from selling stock market shares and other assets at a profit, fell over the two years by more than 29 percent, to $246.8 billion from $349.5 billion. So many companies reduced or halted

dividends after 2000 that by 2002 dividend income had fallen 17.4 percent, to $98.8 billion.

The stock market decline also affected the incomes of those between $1 and $5,000, which includes large numbers of children in affluent families with investments for college costs. Incomes for that group fell 7.8 percent over the two years, to $33.3 billion, as dividends fell and those who had to sell equities in the depressed market to pay tuition reaped smaller gains in 2002.

Two factors appear to be at work in the decline in capital gains income, which is highly concentrated among the wealthy.

The primary factor was the Wall Street debacle, especially the collapse of many dot-coms and telecommunications companies, which eliminated trillions of dollars of paper wealth.

The second was the creation of a large reservoir of losing stocks, which can be sold to offset gains on winning stocks, reducing the amount of capital gains subject to tax for perhaps years to come.

While detailed analysis of how much losing stocks were used to offset income from winning stocks is not yet available from the I.R.S., the agency did report the number of taxpayers who said they had an overall loss in the value of assets they sold. Net capital losses more than doubled, to $29.9 billion from $13.6 billion, and the number of taxpayers with net losses grew 96 percent, to 13.3 million.

During the same two years the number of Americans reporting no income or that they actually lost money for tax purposes exploded, growing 48.5 percent, to 1.7 million in 2002.

These "negative incomes" come primarily from two groups: people closing out a failed business and full-time real estate investors, who are allowed to use paper losses like depreciation to offset their wage income.

The huge increase in the number of people with reported losses is an indication of how many people were wiped out as the widening waves of losses from the dot-com era swamped many vendors, from small businesses to landlords.

Those who reported negative incomes in 2002 reported being $65.6 billion in the hole for that year, 12 percent worse than in 2000.

Pearl Meyer, a leading executive pay consultant in New York, said the stock market even took a toll on the pay to the chief executives of the 200 largest publicly traded companies.

"You can see the effect of the stock market's decline in pay actually taken home each year," she said.

For the 200 executives, stock option profits, which are taxed at the same rate as salaries, fell to an average of $3 million in 2002 from $5.3 million in 2001 and $7.4 million in 2000, Ms. Meyer said.

Total pay for the top 200 chief executives, she calculated from reports to shareholders, plummeted to an average of $7.9 million in 2002 from $12.5 million in 2000.

The collapse of the stock market boom, however, also affected many people well below that level. John A. Caldwell, chief investment strategist for the McDonald Financial Group in Cleveland, said that when "you have a flat stock market over a two- or three-year time period people are less likely to exercise their options."

That is because most people, even if they have a meager gain on their options, delay exercising them in the hope that stock prices will rise before their options expire.

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