ECONOMIC ANALYSIS

Busting Myths About Rich People's Taxes

By Martin A. Sullivan — martysullivan@comcast.net

There are good reasons for the government to keep its hand out of the pockets of the wealthy. For example — and this will be a shocker to most liberals out there — it is a basic tenet of tax economics that an efficient system should eliminate all taxes on capital income. That translates into big tax benefits for the wealthy, who get the lion's share of that income.

That type of thinking recently led Kevin Hassett of the American Enterprise Institute to call the Buffett rule "the stupid rule." "It's basically just a back-door way to hike taxes on capital," he told Bloomberg News (Richard Rubin, "Top Earners Pay Higher Tax Rate Without Buffett Rule," Apr. 10, 2012). To maximize growth, economists would set the tax rate on capital gains, dividends, interest, and all business profits at zero. Yet for all the agreement about the optimality of minimizing taxes on capital, the magnitude of benefits from this policy is highly uncertain.

The economic growth arguments are powerful. But economics has its limitations. It can tell you how to expand the economy. But it cannot tell you how to distribute wealth. You can simply assert — based on your own beliefs — that rich people should not bear a disproportionately larger tax burden than the poor. For example, it is common to hear arguments that it would be fair for all citizens to pay the same rate of tax, or even that all citizens should pay the same amount of tax. Ultimately, fairness is an issue that must be determined on moral grounds.

On the other side of the debate, there are two interesting ways of framing the argument in favor of progressive taxation. The first is called the equal proportional sacrifice principle. Underlying that view is the idea that giving a rich person a dollar generates less happiness than giving a dollar to a poor person. In other words, as income increases there is a "diminishing marginal utility of income." If each person sacrifices an equal portion of his utility from income, the tax system should take not just larger amounts of income but larger fractions of income from the rich than from the poor.

A second argument supporting progressive taxation can be called the social insurance principle of income taxation. According to this view, first developed by Google's chief economist, Hal Varian, there is a lot of uncertainty about where we end up on the income scale. Because most of us are risk averse, we would benefit from buying insurance against the risk of being poor. A progressive income tax is like an insurance plan against being poor. (See "Redistributive Taxation as Social Insurance," *Journal of Public Economics,* 1980.)

Despite all the highfalutin talk, these ideas are nothing more than fancy ways of saying you think rich people should pay a lot more tax than the poor. And, as is the case for those who do not favor progressive taxation, there is no need to use academic arguments. It is perfectly legitimate to simply believe that rich people should pay a higher rate of tax than the poor based on personal views about economic justice.

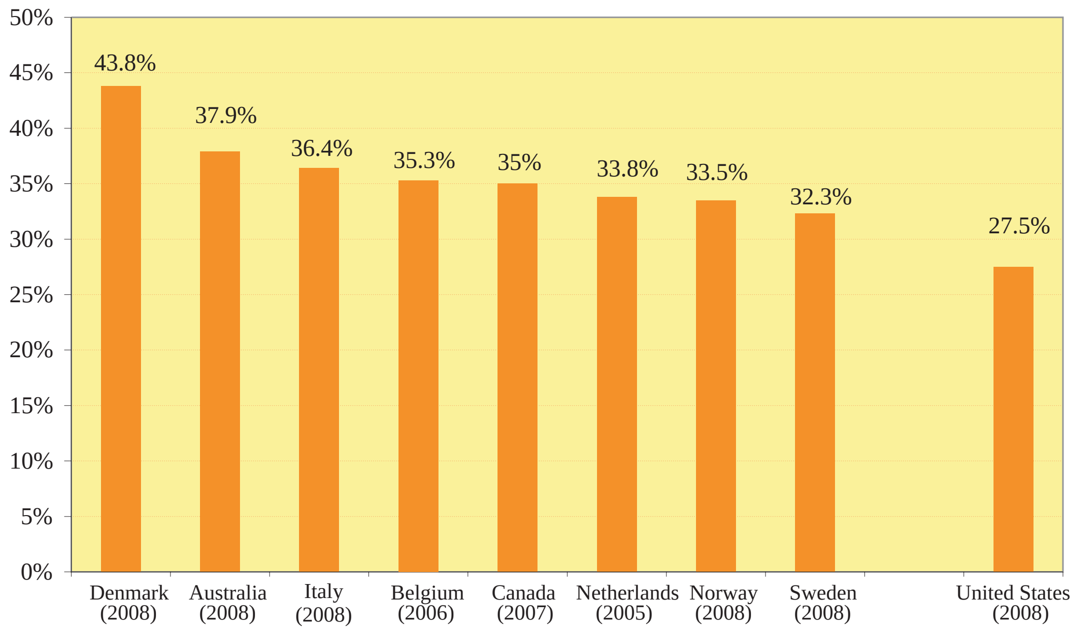
But subjective views are not everything when it comes to fairness. Answers to some factual questions will play a critical role in any real-world debate. For example, what is the current distribution of the tax burden? And how would that change under various proposals? In the highly charged debate over the Buffett rule and extension of the Bush tax cuts for the top income brackets, many facts about income distribution and policies that would change it are getting distorted. The rest of this article tries to correct some of these distortions.

Myth #1: The Buffett rule is largely a symbolic political ploy because it would raise only $5 billion a year.

In a memo dated March 20, the Joint Committee on Taxation reported that the Buffett rule would raise $47 billion over the next 10 years (*Doc 2012-5868*, *2012 TNT 55-30*). Republicans immediately seized on this figure as evidence of purely political motivation behind the proposal and its shortcoming as a serious deficit reduction measure. Republican Sen. Orrin G. Hatch of Utah, ranking minority member of the Senate Finance Committee, said: "The President's so-called Buffett rule is a dog that just won't hunt. It was designed for no other reason than politics — there is no economic rationale for it." The $47 billion estimate is repeatedly cited by the media.

The JCT is Congress's official scorekeeper. Official estimates are scored against official baselines. As clearly stated in the memo accompanying the estimate, the JCT scored the proposal against the current-law baseline. Under current law at the end of 2012, the top ordinary rate increases from 35 percent to 39.6 percent, the dividend rate increases from 15 percent to 39.6 percent, and the capital gains rate increases from 15 percent to 20 percent. It is true that if we revert to a pre-2001 world, the impact of a Buffett rule would be relatively small, as the $47 billion figure suggests. But in the world we are likely to be facing for many years to come — where Republicans have veto power over any tax

Figure 1. Effective Personal Income Tax Rates on Top 1 Percent (latest available year)



Source: OECD, *Divided We Stand*, 2011, Table 9.1.

increases — a Buffett rule would likely raise much more than the oft-quoted $47 billion figure. Tax Analysts has confirmed this with the office of Sen. Sheldon Whitehouse, D-R.I., the lead sponsor of the Buffett rule legislation in the Senate. If the Bush tax cuts are extended, application of the Buffett rule would raise $162 billion over 10 years.

Of course, revenue is not the only reason to favor a minimum tax on the superrich. Surely, antitax conservatives can understand that reports of even a few wealthy households paying inordinately low taxes can violate many individuals' sense of fairness and reduce some of the public's willingness to comply with the tax law.

Myth #2: The United States cannot raise taxes on the wealthy because "there appear to be limits in the real world as to how much tax blood can be extracted from rich turnips" and "the U.S. has the world's most progressive tax burden."

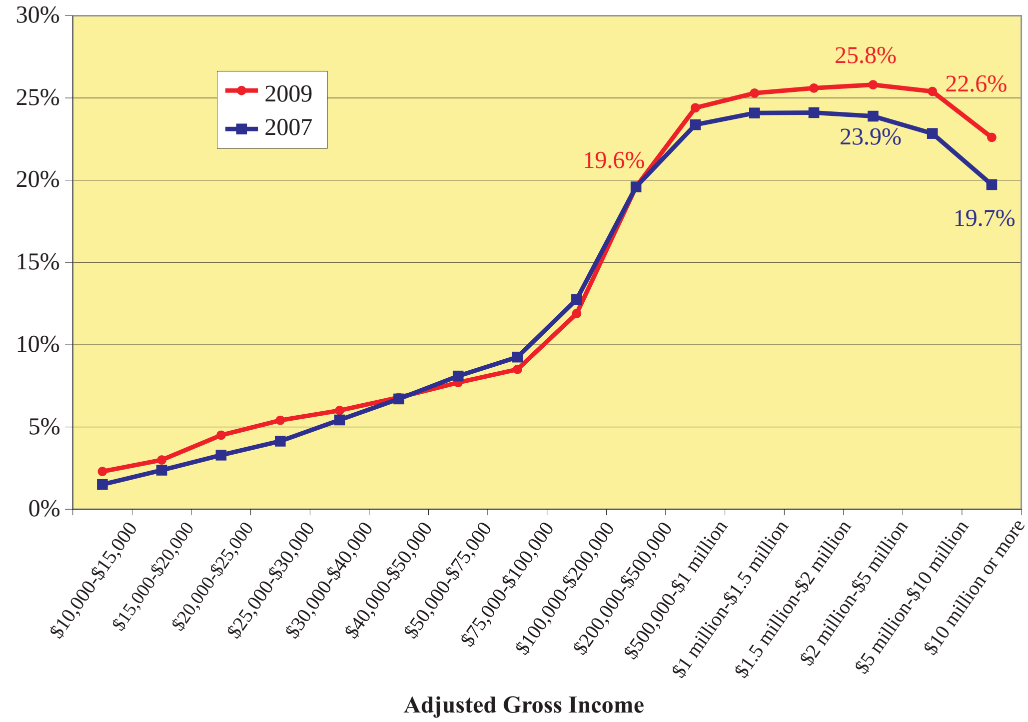
In a recent op-ed in *The Wall Street Journal*, former Sen. Phil Gramm and former Office of Management and Budget Deputy Director Steve McMillin argued that asking the top 1 percent to pay more for fairness' sake is an idea "detached from reality." (See "The Real Causes of Income Inequality," Apr. 6, 2012.) They correctly point out that the top 10 percent of U.S. taxpayers pay a larger share of "household taxes" (that is, income and the employee portion of payroll taxes) than in any other OECD country.

Specifically, the OECD reports that the United States collects 45.1 percent of household taxes from the top 10 percent of households. That puts the United States first among the 24 OECD countries studied. And it is well above the OECD average of 31.6 percent. That is the basis for their claim that the United States has the most progressive tax system. (For the OECD report, see *Growing Unequal? Income Distribution and Poverty in OECD Countries* (2008), Table 4.5, column B.1.)

But in their op-ed, Gramm and McMillin omit many other pertinent facts from the 2008 OECD study, as well as from an update of it (*Divided We Stand: Why Inequality Keeps Rising* (2011). For example, the authors neglect to point out that the top 10 percent of taxpayers in the United States have a larger share of total income than the top 10 percent of taxpayers in most other countries. According to the study, the top 10 percent of households accrue 33.5 percent of all income. Only Poland and Italy have larger figures. The average for the 24 OECD members studied was 28.4 percent (OECD (2008), Table 4.5, column B.2).

They also neglect to point out that although the *share* of taxes paid by the wealthy may be larger in the United States than in other countries, the tax *burden* as a percentage of income is smaller because the United States is a low-tax country. For the nine OECD countries for which data are available, the top 1 percent of taxpayers in the United States paid

Figure 2. Effective Income Tax Rates in 2007 and 2009, by Income Category



Source: IRS Statistics of Income division, "Individual Complete Report (Publication 1304)," Table 1.1.

less personal income tax as a percentage of income than in any other country. The data are shown in Figure 1. The 27.5 percent burden in the United States is considerably below the average of 36 percent for the other eight countries. If, as the authors suggest, international comparisons should serve as a guide for domestic policy, there is plenty of room for higher taxes on wealthy Americans.

> ***The United States must choose whether it wants an income tax that is progressive over all income categories or whether it wants large tax benefits for capital gains and dividends. It can't have both.***

The most serious shortcoming of the Gramm-McMillin analysis is the authors' omission of one of the main conclusions of the OECD studies:

> The redistributive effect of the welfare state is generally larger for public cash benefits than for household taxes — except in the United States, which achieves more redistribution through the tax system than through the transfer system (OECD, 2008, p. 119).

In other words, in most countries income redistribution is achieved primarily through spending programs rather than through the tax system. The United States is the exception to the rule. If you look exclusively at the tax system as Gramm and McMillin do, the U.S. government appears to be redistributing wealth more aggressively than Denmark and Sweden. But when the effects of both spending and taxation are taken into account, the data show that the United States does far less redistribution than other countries (OECD (2011), Table 7.3, column 5). Gramm and McMillin imply that other countries with less progressive tax systems are simply "feeding government" rather than alleviating poverty and the burdens of low-income families. But in fact the opposite is true: Other countries are doing considerably more redistribution than the United States.

Myth #3: The United States has a progressive income tax.

Almost everybody assumes the individual income tax is progressive — that is, that higher income categories pay higher effective tax rates than lower income categories. That is true only up to a point, as shown in Figure 2. The schedule of effective tax rates in the United States is not steadily upward sloping. Depending on the year, average tax rates begin declining somewhere in the $2 million to $5 million range. For adjusted gross income over $10 million, the average effective tax rate was 19.7 percent in 2007 and 22.6 percent in 2009. The income tax is regressive at the upper end.

There is a simple explanation for both the declining rates at the top end and the rise in top-end rates in 2009 over 2007: the 15 percent rate on capital gains and qualified dividends. As income rises, an increasingly larger share of income comes in the form of dividends and capital gains. And there were more capital gains in the boom year of 2007 than there was in the depths of the recession in 2009.

Application of the Buffett principle would eliminate the dip in tax rates at the high end. The Buffett rule is roughly equivalent to an increase in the tax rate on capital gains and dividends on millionaires. The United States must choose whether it wants an income tax that is progressive over all income categories or whether it wants large tax benefits for capital gains and dividends. It can't have both. ■

NEWS ANALYSIS

Demystifying the End of LB&I Tiering

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With the IRS Large Business and International Division expected to replace its much-maligned tiered issue structure soon, taxpayers are wondering whether the new system represents real progress on targeted issue coordination or simply repackaged uniformity that will fall prey to the same criticisms as tiering.

Government officials have offered hints at the new direction being taken in LB&I regarding troublesome issues affecting a large number of cases, but taxpayers always want specifics because details matter in individual cases. The hope is that exam teams will be given more autonomy to resolve case issues without experiencing a bottleneck from expert teams.

Dead or Not?

The technical status of the tiered issue process is unclear; officials have avoided directly saying the tiering system is gone for good. LB&I Commissioner Heather Maloy acknowledged last fall that the system would be replaced by a "knowledge management" process. Maloy has also said that LB&I's use of issue practice groups (IPGs) is "much more than managing issues," with the ultimate focus being on more efficiently managing expertise across the division. (For prior coverage, see *Tax Notes*, Nov. 7, 2011, p. 658, *Doc 2011-22967*, or *2011 TNT 212-1*.)

> ***The pilot shows that LB&I is trying to move in a new direction and address some of the problems associated with the tiered system, Goldberg said.***

Steven Miller, IRS deputy commissioner for services and enforcement, said last month that IPGs bring together subject matter experts to "enhance collaboration" and provide a peer network that field examiners can rely on. IPGs will "work much better than the tiered process," he said. (For Miller's prepared remarks, see *Doc 2012-7336* or *2012 TNT 68-54*.)

The old tiering process still seems to be alive for now — at least in formal documents. The IRS website still has a page on issue tiering that labels issues Tier I, Tier II, and Tier III, identifying those with an active status versus those being monitored.