



GEORGE WILL

On the crisis of the welfare state

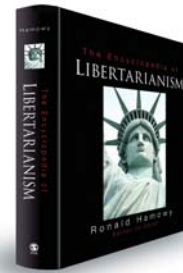
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Zimbabwe inflation: 12,500,000 percent

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Inequality and Taxes

BY ALAN REYNOLDS

Every contest for the presidency is also a contest among interest groups, think tanks, and journalists eager to gain attention and influence public policy by persuading candidates to adopt their agenda as a campaign theme.

Income inequality has long been a favorite rhetorical device to promote such disparate policies as tariffs, immigration restrictions, or subsidies to builders of low-income housing. In the current election cycle, the mantra of “rising inequality” is incessantly used as a rationale for punitive tax policies toward high-income taxpayers and even middle-income investors—proposals rarely defended on their economic merits. “Fairness” arguments often seem to drown out serious debate about the potential impact of higher marginal tax rates on economic efficiency, incentives, tax avoidance or economic growth. This campaign for higher tax rates on upper incomes invariably relies on measures of incomes among the “top 1%” as reported on individual income tax returns (a strange average of incomes ranging from about \$350,000 to \$3.5 billion).

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In *D.C. v. Heller*, the Supreme Court clearly declared that the Second Amendment protects an individual right to keep and bear arms. Robert A. Levy, a Cato senior fellow and board member, may not own a gun, but he acted as “prime mover” of the case, financing it, assembling the original plaintiffs, and guiding the case through the lower courts. Pictured from left to right at the Court after the decision: Levy (wired for radio interviews), who acted as co-counsel throughout, plaintiff Dick Heller, and lead counsel Alan Gura talk to reporters following the historic decision.

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“Bad statistics are never a good excuse for enacting bad policies.”

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Telling this story always involves picking two dates very carefully, as if that described an ongoing trend.

The Old Two-Year Ruse (start with 1979)

In June 2007, the Pew Charitable Trust’s “Mobility Project” was launched with a pamphlet written by project director John E. Morton, former foreign policy adviser to Sen. John Kerry’s presidential campaign, and Isabel Sawhill, associate director of the Office of Management and Budget under President Bill Clinton. The first sentence noted that “the convergence of a presidential election cycle” and “income inequalities last seen nearly a century ago” provide “a unique opportunity to refocus the debate.”

The document claimed that the United States “is a society with rapidly growing income inequality,” noting that “the Congressional Budget Office [CBO] finds that between 1979 and 2004, the real after-tax income of the poorest one-fifth of Americans rose by 9 percent, that of the richest one-fifth by 69 percent, and that of the top 1 percent by 176 percent.” Yet “rapidly growing” surely implies inequality *is* growing rapidly *in the present*, not the past. Comparing 1979 and 2004 shows that something happened between those two dates, but not *what* happened or *when*. If we needed only two years to define a trend, then the same CBO estimates would show that the share of income for the top 1% was 12% in 1988 and 12.2% in 2003. It is no accident that the Mobility Project started with 1979.

One thing that happened between 1979 and 1988 is that marginal tax rates on individuals stopped being higher than tax rates on corporations. The textbook *Taxes and Business Strategy*, by Myron Scholes and others, shows that “pre-1981 . . . many doctors, lawyers and consultants incorporated to escape the high personal tax rate.” After the highest individual tax rate fell from 70% to 28%, they added, “many of the corporations converted back” to partnerships, LLCs, and Subchapter-S corporations.

Shifting income from the corporate tax to the individual tax created an illusory increase in top incomes in studies by the CBO and by economists Thomas Piketty and Emmanuel Saez in their 2003 study “Income Inequality in the United States, 1913–1998,” which is regularly updated on Saez’s website. Business income was only 11.1% of the reported income of the top 1% in 1986, according to Piketty and Saez, but that fraction nearly doubled in only two years to 21.2%. The unusually rapid increase in *reported* top incomes between 1979 and 1988 largely reflects increased incentives to earn more income in taxable cash (rather than perks), and to report that income on *individual* (rather than corporate) tax returns. But it also reflects the fact that inflation fell from 13.3% at the end of 1979 to 4.4% by 1988, greatly increasing the value of bonds and stocks. That, in turn, added to capital gains and stock option payoffs in the CBO estimates of top incomes—particularly in 1986, when there were huge sales of appreciated assets to avoid a higher tax in 1987. To now look back on 1979 as an ideal example of low inequality is ironic, because the runaway inflation of 1979 and the subsequent three-year recession hurt rich and poor alike.

Conflicting Evidence

Using the same CBO figures, if the income gains are measured from 1988 instead of 1979, the increase in the income of the top 1% drops from 176% to 47%, the increase for the top fifth drops from 69% to 31%, and the increase among the bottom fifth rises from 9% to 16%. In other words, nearly all of the “rapidly rising” inequality happened between 1979 and 1988—a period that ended 20 years ago. Some rise in inequality still remains in this particular set of data, to be sure, even after eliminating the exaggeration resulting from using 1979 as

the base year. Yet other measures of income show a quite different pattern of gains, particularly for low-income households.

Table 1 shows two estimates of the changes in *before-tax* income gains for the poorest, richest, and middle fifths of households. The first column is from a May 2007 CBO study, “Changes in the Economic Resources of Low-Income Households with Children,” and it begins with the 1991 recession and ends with 2005 (<http://www.cbo.gov/ftpdocs/81xx/doc8113/05-16-Low-Income.pdf>). This report was based on Census Bureau income plus transfer payments, notably the earned income tax credit (EITC). The second column covers all households, using the Federal Reserve’s triennial Survey of Consumer Finances from the cyclical peak of 1989 to 2004 (<https://www.federalreserve.gov/pubs/oss/oss2/2004/bulletin.tables.pub.xls>). The SCF uses a broader measure of income than the usual Census Bureau definition, including realized capital gains, business income, and transfer payments.

TABLE 1
ESTIMATED GROWTH OF REAL INCOME

	CBO 1991-2005	SCF 1989-2004
Poorest Fifth	35.0%	23.4%
Middle Fifth	17.3%	14.1%
Top Fifth	53.2%	18.3%

Both surveys show relatively large increases in real, inflation-adjusted income among both the poorest and richest fifths, with smaller gains in the middle. The percentage gains for the top and bottom fifths appear much larger in the CBO figures partly because that study begins with the 1991 recession, which exaggerates cyclical change. In the SCF figures, the 1989–2004 income gains among the poorest fifth (23.4%) and second-poorest (20.9%) exceeded the gains among the top 10% (18.3%), which does not meet any definition of rising inequality.

“It is clearly illogical to point to income before taxes to suggest that the rich do not pay enough taxes.”

The Pew report, as well as sensational news stories this year in *The New York Times* (April 9) and the *Wall Street Journal* (April 19), suggested there was something unusually bad about the fact that real median household income in 2006 had not yet gotten back to the peak level of 2000. Yet in the last business cycle median income was also well below the 1989 peak in 1995, after six years, and only \$34 higher in 1996 (despite cheap oil). Moreover, the relatively slow growth of middle income in CBO and SCF data shows why the similar measure of median income is *not* a reliable approximation of how real income in general has grown. In both studies, 80% of the population experience more rapid real income growth than the middle did.

A New Two-Year Ruse (start with 2002)

Those who cite rising inequality as the reason for undoing the most economically significant tax rate reductions of 2000–2003 must realize they need evidence about what happened since 2000, not since 1979. Lacking the required proof that the “Bush tax cuts” resulted in a dramatic increase in after-tax inequality since 2000 (and therefore should be repealed), proponents of higher tax rates resorted to misleading statements about before-tax incomes since 2002.

Writing in the May 1 issue of *Time*, Justin Fox said, “According to economists Thomas Piketty and Emmanuel Saez, 75% of all income gains from 2002 to ’06 went to the top 1%—households making more than \$382,600 a year.” Noting with approval that “Obama in particular has been explicit about wanting to shift more of the income-tax burden . . . onto those making more than \$200,000 a year,” Fox blamed inequality on President Reagan’s tax cuts and cited a recent poll showing 51% favor “heavy taxes on the rich.” Yet his figures, from Piketty and Saez, refer to income *before taxes*.

Citing the same Piketty and Saez calculations, *Wall Street Journal* columnist David Wessel added “the trend didn’t begin with President Bush’s election, but he didn’t do

much to arrest it.” What could he have done? Raising tax rates on the rich or transfers to the poor could not change these numbers, because Piketty and Saez *exclude* taxes and transfers. “There is significant disagreement among politicians and voters about . . . how much the tax code should redistribute income,” wrote Wessel, noting that “Sen. Obama would wield the tax code more aggressively than Senator McCain.” This alleged policy debate relies on statistics that exclude taxes in order to rationalize the use of higher tax rates to reduce high incomes. That makes no sense.

The statistics were lifted uncritically from a March 15 memo by Emmanuel Saez of the University of California at Berkeley, “Striking It Richer.” Saez compares the 1993–2000 Clinton expansion with the Bush 2002–2006 expansion, concluding that “during both expansions, the incomes of the top 1% grew extremely quickly at an annual rate over 10.1 and 11.0% respectively.” But that is only because he starts with 2002, after stock prices had collapsed, and includes capital gains. Realized capital gains fell from 6% of GDP

in 2000 to 2.4% in 2002, and then recovered to 5.2% in 2006.

The first column of Table 2 shows the Piketty and Saez estimates of average (mean) income for the top 1%, measured in 2006 dollars and including capital gains. These figures supposedly show that real incomes of the top 1% have been growing very rapidly under Bush, just as they did during the tech stock boom of 1997–2000. In reality, top incomes doubled from 1993 to 2000, but then fell 31% by 2002. For the remaining 99%, by contrast, real income fell by only 4% from 2000 to 2002. Saez claims incomes of the top 1% continued to rise “extremely quickly” after the Clinton years, both in absolute terms and also relative to other incomes. For the whole period from 2000 to 2006, however, his figures show that real income of the top 1% rose by 9% (from \$1.185 trillion to \$1.243 trillion), while the real income of everyone else rose by 9.8% (from \$6.22 trillion to \$6.83 trillion).

The second column shows the *declining share* of top incomes received from salary, bonuses, and stock options. Saez, however, says, “A significant fraction of the surge in top incomes since 1970 is due to an explosion of top wages and salaries.” That was true from 1966 to 1988, and from 1994 to 2000, but not since then. His data show that real *labor* income of the top 1% was flat from 1988 to 1994, rose 65.7% from 1994 to 2000, and then *fell* 8.4% from 2000 to 2006.

The relatively small increase in top 1% incomes from 2000 to 2006 is mainly because of income shifting—the business share of the top 1% of income rose from 27.4% in 2002 to 30.1% in 2006, after individual and corporate tax rates became the same. Lower tax rates on dividends also raised taxable top incomes. Dividends accounted for only 4.2% of top percentile incomes in 2002 (aside from capital gains), but 7.4% in 2006. When capital gains were included, they accounted for 5.8% of the income of the top 1% in 2000, 2.3% in 2002, and 4.4% in 2006. It is not difficult to imagine why Saez chose to include capital gains and to measure top income gains from 2002 rather than from 2000.

TABLE 2
AVERAGE BEFORE-TAX INCOME OF THE TOP 1% (IN 2006 DOLLARS, INCLUDING CAPITAL GAINS)

	INCOME (\$)	SALARY SHARE (%)
1993	596,525	59.8
2000	1,185,533	56.9
2002	820,102	58.7
2006	1,242,595	48.4

Source: Thomas Piketty and Emmanuel Saez, “Updated Tables,” Tables A6 and A7, <http://elsa.berkeley.edu/~saez/TabFig2006.xls>. Salary share adapted from Table A7 (which excludes capital gains) to define income to include capital gains.

“Telling a story about rising inequality always involves picking two dates very carefully.”

Imagine There's No Taxes . . .

The Brookings Institution began a new policy program in 2006, the Hamilton Project—founded by former Treasury secretary Robert Rubin. The first director was Peter Orszag, now head of the Congressional Budget Office. The project's seminal statement on tax policy, “Achieving Progressive Tax Reform,” was coauthored in June 2007 by former Treasury secretary Larry Summers; Jason Furman, now economic director for the Obama campaign; and Jason Bordoff, the new project director.

The paper acknowledged that “excessively high tax rates distort economic behavior by changing the incentives to work, save, and invest, which can harm economic performance.” Yet the key theme was to assert that “rising inequality strengthens the case for progressivity.” Proof of such rising inequality again relied on CBO estimates of income changes since 1979. Like Saez, Summers, Furman, and Bordoff emphasized *before-tax* data: “In 1979,” they wrote, “the before-tax income of the most affluent 1 percent of the U.S. population already equaled that of the bottom 26 percent. That share has since risen nearly continuously, reaching 45 percent in 2004.”

Even if those figures were credible, they are *irrelevant* to the policies being prescribed. It is clearly illogical to point to income *before taxes* to suggest that the rich do not pay enough taxes. It is also illogical to point to income *before transfer payments* to prove that the poor do not receive enough transfer payments. The before-tax CBO estimates exclude the refundable earned income tax credit (EITC). The authors' estimates also rely on Piketty and Saez, who exclude *all* transfer payments. If transfer payments are excluded, the Census Bureau calculates that incomes of the poorest fifth in 2006 averaged only \$5,208 but their *disposable* income—including transfers—was \$12,329. Similarly, the *before-tax* income of the richest fifth averaged \$182,505, but their *disposable* income—after taxes—was \$137,293.

The Hamilton Project paper claims that

“the tax system itself has become considerably less progressive. Reductions in taxes have been particularly dramatic for very high income taxpayers.” That comment cannot refer to individual income taxes, as presidential policy debates assume. CBO estimates the individual income tax rate among the top 1% fell modestly from 21.8% in 1979 (when the top tax rate was 70%) to 19.9% in 1989 (when the top tax rate was 28%) and 19.4% in 2005 (when the top tax rate was 35%).

By contrast, reductions in taxes *have* been “particularly dramatic” for the middle fifth, whose average tax was slashed from 7.5% in 1979 to 5% in 2000 and 3% in 2005. For the poorest fifth, the tax rate fell to *minus* 1.6% in 1989, *minus* 4.6% in 2000, and *minus* 6.5% in 2005—reflecting the expansion of refundable tax credits. In the same paper, Summers, Furman, and Bordoff argue that the progressive 1986–2003 reductions in income tax for the bottom 40% have now made it “regressive” to reduce anyone else's income tax: “The bottom 60 percent of households pay less than 1 percent of total income taxes,” they write, so “any income tax cuts that do not include expansions in refundable credits such as the EITC are therefore necessarily regressive.” Making that comment even more ironic, the authors *exclude* the EITC when adding-up incomes of the bottom 40%.

In reality, the authors' claim that taxes have become “less progressive” cannot and does not refer to the reduction in *individual* income tax rates. Instead, it mainly refers to a CBO estimate that the effective corporate rate on the top 1% fell from 13.8% in 1970 to 6.7% in 2000—before rising to 9.9% in 2005. That timing makes it difficult to blame the 2001–2003 tax cuts for making taxes “less progressive.” Besides, the CBO's technique for distributing the corporate tax is seriously flawed.

Adding Two-Thirds of Corporate Tax to Top Incomes

Believe it or not, the CBO adds two-thirds of *corporate taxes* to the before-tax income of households of the top 1%. They do that to estimate what share of that tax is borne by the top 1%. Yet adding most corporate taxes to top incomes makes before-tax CBO figures a particularly untenable way to measure changes in top incomes. CBO economists reason that the corporate tax is borne by owners of capital in general. Unfortunately, they then make an indefensible leap by estimating the ownership of capital by looking at only the dwindling portion of capital gains, dividends, interest income and rent still reported on tax returns. As a result, the estimated share of corporate taxes added to top 1% incomes rose from 34% in 1979 to 66.4% in 2004. And that, in turns, accounts for a sizable portion of that 1979–2004 increase in top “incomes” (including corporate taxes) used to defend the Hamilton Project's uneasy case for steeper marginal tax rates on incomes well below the top 1%.

The top 1% could not possibly have received 66.4% of the nation's investment returns in 2004. Their share of wealth was 33.4% according to the SCF, and closer to 21% according to a study co-authored by Saez. Neither study finds any upward trend in wealth inequality, so assigning 66.4% of capital income to the top 1% is literally unbelievable. The only reason the top 1% accounts for a rising share of *taxable* savings is that a rapidly increasing share of everyone else's savings is now sheltered in tax-free retirement plans. Returns on those investments will *never* be reported to the IRS as dividends, interest, or capital gains, because distributions from deferred plans are reported as ordinary income while capital gains or dividends from Roth IRAs are never reported. Most capital gains on home sales also vanished from tax returns since 1997.

The CBO's statistical blunder of using *taxable* investment returns to guess the share of corporate taxes for the top 1% resulted in

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ance with a refundable tax credit for individuals. At the same time he would sharply deregulate the insurance industry to increase competition.

Trade After Doha

The bad news is that the Doha round of World Trade Organization negotiations collapsed without a new agreement being reached. The good news is that improving the international trading system does not



require a new, comprehensive multilateral agreement. In “While Doha Sleeps: Securing Economic Growth through Trade Facilitation” (Policy Analysis no. 37), Daniel J. Ikenson, associate director of Cato’s Cen-

ter for Trade Policy Studies, says countries can derive large gains by cutting bureaucratic red tape to the import and export of goods, a policy known as trade facilitation. Such reforms could do more to increase global trade flows than further reductions in tariff rates. For many developing countries—particularly those that receive preferential tariff treatment from rich countries—reducing transportation and logistics-related costs through trade facilitation reforms would be much more beneficial than further tariff cuts. With the assistance of Cato’s media team and the International Policy Network, op-eds by Ikenson based on this study appeared in the *Wall Street Journal*, the *Jerusalem Post*, the *Straits Times* of Malaysia, the *Sunday China Post*, *Business Day* of South Africa, the *Daily News* of Egypt, the *Mint* of India, *El Universal* of Caracas, the *South China Morning Post*, the *Australian*, and many other papers.

A New Tool for School Choice Analysis

Education tax credits—programs that allow individuals to deduct education

expenses from their tax liabilities or corporations to do the same for donations to scholarship funds—are a great way to put consumers back in charge of education. But according to “The Fiscal Impact of a Large-Scale Education Tax Credit System” (Policy Analysis no. 618), they would also save billions of dollars for state governments if enacted. Andrew Coulson, director of Cato’s Center for Educational Freedom, and Ball State University economist Anca Cotet estimate the effect that model legislation for tax credits would have on the budgets of five different states. In its first 10 years of operation, savings from the model education tax credit bill would range from \$1.1 billion for South Carolina to \$15.9 billion for Texas. Illinois, Wisconsin, and New York would also see 10-year savings in that range. Accompanying the report is the Fiscal Impact Calculator, a generalized spreadsheet tool capable of calculating the fiscal impact of education tax credits on other states. This tool is available to state policymakers, pundits, and other interested parties at www.cato.org/pub_display.php?pub_id=9515.

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nearly \$150 billion being added to the “before-tax income of the most affluent 1 percent” in 2004. That huge miscalculation, in turn, was critical to the Hamilton Project’s unexplained assertion that “rising inequality strengthens the case for progressivity.”

The Brookings-Urban Tax Policy Center also uses the CBO’s erroneous method to estimate how the corporate tax is distributed. As a result, they estimate that top 1% would receive two-thirds of the benefit from Senator McCain’s proposal to cut the corporate income tax. Such estimates are not credible.

Unpaid Taxes Don’t Pay Bills or Redistribute Income

The fundamental problem with trying to measure income from individual tax returns is that people try to minimize their taxes. Many studies find that an increase in marginal tax rates on capital gains or high incomes causes income reported from those

sources to drop significantly. Economists call this “the elasticity of taxable income.”

If the tax rate on dividends is increased, investors will shift many of their dividend-paying stocks into tax-exempt pension funds or sell them to tax-exempt domestic and foreign investors and hold more tax-exempt bonds. If the tax rate on capital gains is increased, investors will hold fewer shares in taxable accounts and avoid selling winning stocks unless they have offsetting losses. If the highest individual income is raised far above the corporate tax rate, thousands of professionals and businesses currently filing as partnerships, Subchapter S corporations, and LLCs will reincorporate to shelter income under the corporate income tax.

Because of such well-documented responses, income tax data provide incorrect information about income distribution when tax rates change. A large body of evidence finds large and sustained increases in

reported income among high-income taxpayers in the wake of major reductions in tax rates on salaries (1988) or capital gains (1997) or both (2003). It follows that we could expect sustained reductions in reported income among high-income taxpayers if there were major increases in marginal tax rates on high individual incomes and/or capital gains. Such defensive moves by targeted taxpayers would indeed appear to reduce before-tax top incomes reported on individual tax returns. But it also means the higher tax rates would be largely or entirely ineffective in reducing after-tax income or in raising additional revenue.

Dubious estimates of relative income changes since 1979 or 2002, usually constructed from before-tax IRS data, are being widely cited as a sufficient justification for embracing tax policies that are undeniably harmful to economic progress and prosperity. Bad statistics are never a good excuse for advocating bad policies. ■