



# THIS IS FAIR?

A look at who's actually paying taxes and how the tax code impacts our economic growth reveals that dire change is needed—but not the kind of change that's being pushed by the White House.

by Daniel J. Mitchell

Beginning as a simple two-page form in 1913, the internal revenue code has morphed into a complex nightmare that simultaneously hinders compliance by honest people and rewards cheating by Washington insiders and other dishonest people. But that is just the tip of the iceberg. The tax code also penalizes economic growth, distorts taxpayer behavior, undermines American competitiveness, invites corruption and promotes inefficiency.

There are three broad reasons the tax code has become a national disgrace:

**Class warfare.** Some politicians seek to gain votes by pitting one group against another, and soak-the-rich taxes are a common manifestation of this impulse. Lawmakers figure that taxes imposed on a small slice of the population—such as the top 10 percent of earners—will be welcomed by the envious and ignored by everyone else.





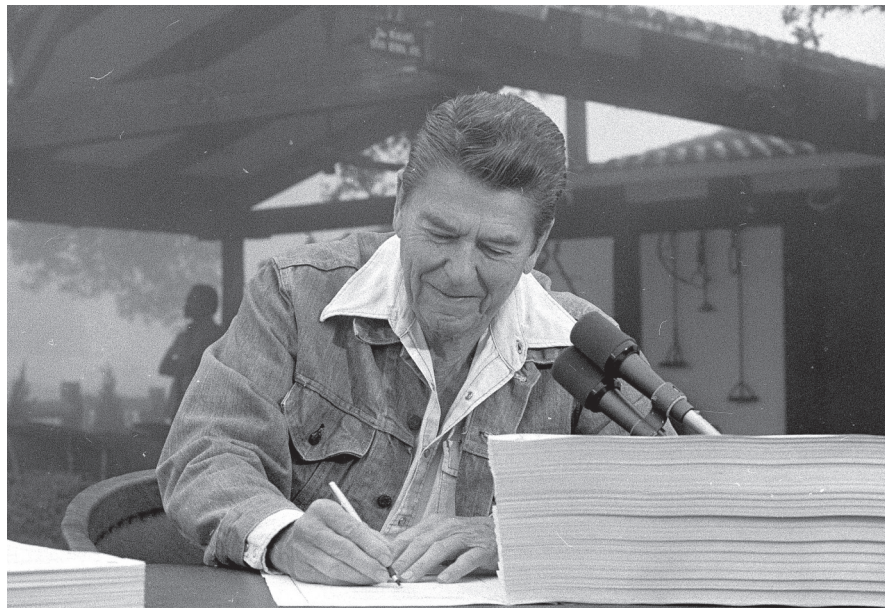
**Social engineering.** The ability to manipulate behavior through the tax system gives politicians considerable leverage, and they are not shy about using that power to impose their values. By tilting the playing field (economists would say “by changing relative prices”), lawmakers seek to influence both the source of income and the use of income.

**Legal corruption.** Many loopholes, exclusions, deductions, credits, exemptions and other preferences are in the tax code solely because of campaign contributions and other forms of political support.

Ironically, these three factors often work at cross purposes, and the results can be quite perverse. Politicians impose high tax rates and support punitive double taxation of saving and investment because they want to go after the so-called rich. Yet the vast majority of tax preferences benefit upper-income taxpayers. Politicians claim that social-engineering tax breaks such as the itemized deductions for home mortgage interest and charitable contributions are for the middle class, for instance, but the overwhelming benefit flows to those making more than \$100,000 per year. The special tax loopholes in the code, needless to say, are almost entirely for the benefit of wealthy (and politically sophisticated) people and businesses. (see *Figure 1*)

The best way to solve all the current problems is to repeal the entire internal revenue code and replace it with a simple and fair system such as the flat tax. If the 16th Amendment could be repealed, another great option would be a national sales tax plan such as the Fair Tax. Unfortunately, rather than move in the right direction, politicians in Washington want to make the tax code even worse. Obama has stated that he wants the rich—however they are defined—to pay higher income tax rates. He also wants them to pay higher payroll tax rates, and he wants to increase the double taxation of their dividends and capital gains. Last but not least, he wants to also hit them with a 45 percent death tax if they create a nest egg for their children.

This radical agenda shows that the



In 1981, President Ronald Reagan signed the largest tax cut bill in U.S. history at his ranch near Santa Barbara, Calif. Under Reagan, the top tax rate was cut from 70 percent to 28 percent. This cut led to increased federal revenues. (AP/Charles Tasnadi)

administration is clearly taking a class-warfare approach to the tax code. But this does not preclude other changes that will make the internal revenue code more convoluted. Obama has a bunch of gimmicky tax proposals, including the temporary payroll tax credit that already was enacted as part of the so-called stimulus. These nanny-state proposals obviously increase the level of social engineering in the tax code. The president also has quickly learned to play the corrupt game of providing special loopholes to the big-money crowd. The tax break in the “stimulus” legislation for a Microsoft billionaire would be a good example.

These are the add-insult-to-injury aspects of Obama’s tax agenda. Social engineering and special loopholes undermine efficiency by luring people into making decisions for tax purposes, but the economic consequences of the class-warfare provisions are far more troubling. Persecuting so-called rich people with oppressive tax rates may be a good way to win elections, but it’s not a good idea for the economy unless you think America should be more like France, with high unemployment and lower living standards. Higher tax rates—especially steeper tax rates on investors and entrepreneurs—are misguided.

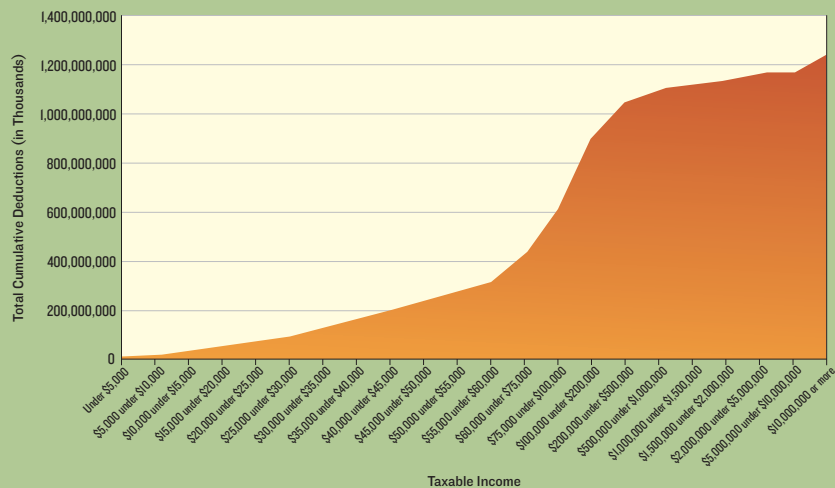
#### **HIGH TAX RATES ON THE RICH REDUCE INCENTIVES FOR PRODUCTIVE BEHAVIOR.**

Ronald Reagan used to say that when you tax something, you get less of it, and when you subsidize something, you get more of it. Politicians actually understand this principle when it suits their purposes. They routinely seek to impose higher taxes on things such as alcohol and tobacco, and they explicitly argue that higher “sin” taxes are necessary to discourage drinking and smoking. Setting aside the question of whether government should try to control people’s private lives, the politicians are right about the impact of higher tax rates. Higher “sin” taxes do reduce smoking and drinking. (They also encourage smuggling and other forms of criminal activity, but that is a separate issue.)

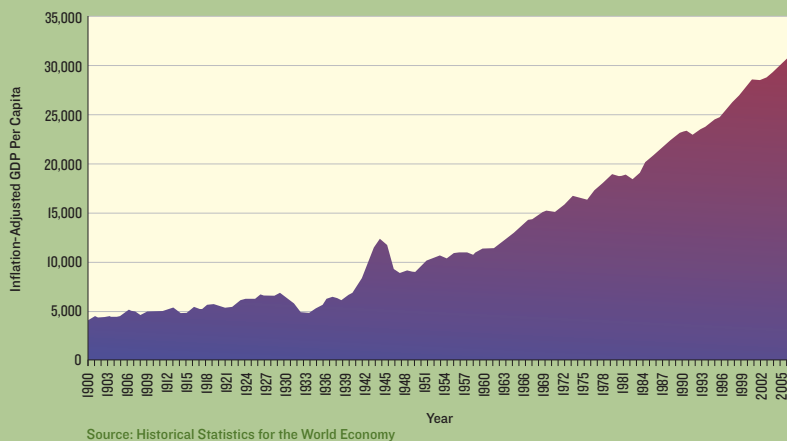
Unfortunately, politicians conveniently forget about economic analysis when they decide they want to tax productive behavior. And just as high “sin” taxes discourage drinking and smoking, high income tax rates discourage work, saving, investment and entrepreneurship. Some proponents of class warfare actually favor this result since they think the economy is a fixed pie and that ordinary people get less money



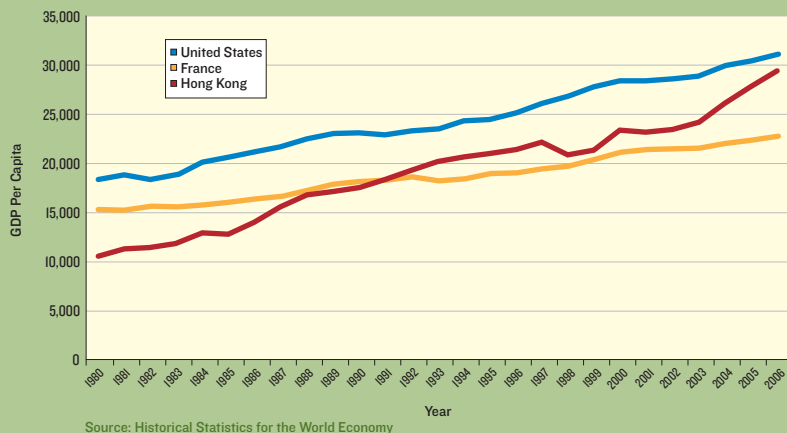
**Fig 1. Cumulative Total Deductions by Income Level (2006)**



**Fig 2. Growth in Living Standards**



**Fig 3. Comparison of GDP Per Capita Across the United States, France, and Hong Kong**



when someone such as Bill Gates earns a lot of money. This is a grotesquely inaccurate assumption. The pictured chart shows how living standards in America, as represented by per capita economic output, have grown enormously over time. (see Figure 2)

The more knowledgeable class-warfare advocates admit that the economy does expand, and they even acknowledge that growth helps the less fortunate, but they assert that high tax rates do not make much of a difference to the economy's performance. There is a wealth of evidence, though, showing that tax rates are a key factor. Tax rates are one of the reasons why zero-income-tax states such as Texas, Nevada, Tennessee and New Hampshire generally grow faster than states with harshly progressive tax systems such as California, New Jersey and New York. Likewise, low tax rates help explain why jurisdictions such as Hong Kong grow faster than the United States—and differences in tax burdens also help explain why both Hong Kong and the United States grow faster than high-tax nations such as France. (see Figure 3)

This does not mean that taxes are the only important variable. Indeed, sound money, rule of law and property rights are probably even more important. And trade policy, regulatory policy and spending policy also can have a big impact on economic performance. But when researchers isolate the effect of taxes, they find that high tax rates and onerous tax burdens are associated with slower growth. But it does not require a Ph.D. to understand this relationship. As Winston Churchill famously said, “[F] or a nation to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.”

### HIGH TAX RATES ON THE RICH WON'T RAISE MUCH REVENUE.

Many people think that politicians like higher tax rates because that gives them more money to spend, but that may not be a reasonable assumption. It is true, of course, that politicians like to spend other people's money. But it's not automatically true that higher tax rates will lead to more tax revenue.

High tax rates discourage people



from working, saving and investing. This means they earn less taxable income. High tax rates also encourage people to hide, shelter and under-report their income, and this tax avoidance and tax evasion also reduces taxable income. And if taxable income falls enough, it can completely offset the impact of the higher tax rate, meaning less revenue. This is what is known as the downward-sloping portion of the famous Laffer Curve, where tax rates are so high that tax cuts actually result in more revenue. (see Figure 4)

A good example comes from the 1980s, when Ronald Reagan reduced the top tax rate from 70 percent to 28 percent. Many leftists complained that this would be a windfall for the rich that would deprive the government of revenue. Yet, just as “supply-siders” predicted, the amount of income reported by the rich jumped by a huge amount between 1980 and 1988. The increase in taxable income was so immense that the amount of tax collected at a 28 percent tax rate was larger than the amount of tax collected with a 70 percent tax rate. (see Figure 5)

The Reagan tax cuts are a special case, though, because the tax rate used to be at confiscatory levels. It is very unlikely that lower tax rates today would increase revenue (or that a tax rate increase would lose revenue). This is because we are probably on the upward-sloping portion of the Laffer Curve. But that does not mean it is a good idea to raise tax rates. After all, the goal should be for the tax rate to be set at the growth-maximizing level, not the revenue-maximizing level. So even though Obama’s proposed tax hikes probably would lead to more revenue, at least in the short run, the economy would suffer and taxable income would fall. The IRS would collect a bit of additional revenue because the effect of the higher tax rate would more than offset the impact of decreased taxable income, but that would be a high price to pay for the nation.

Of course, sometimes politicians like higher tax rates solely for reasons of spite. Obama said during the campaign, for instance, that he wanted to raise the capital gains tax rate even if the government collected less money.



Fig 4. Laffer Curve

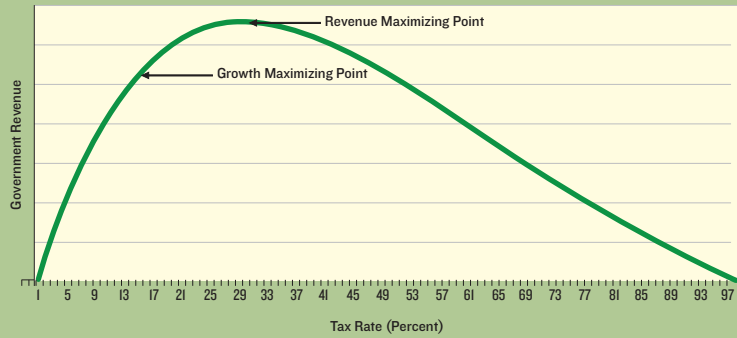


Fig 5. 1980 and 1988 taxes paid on income over 200k

1980			
	Returns	Taxable Income (\$Millions)	Income Tax Paid (\$ Millions)
200k - 500k	99,971	22,696.01	11,089.11
500k - 1mil	12,397	6,512.42	3,613.2
1 mil +	4,389	7,013.23	4,301.11
	116,757	36,221.66	19,003.42

1988			
	Returns	Taxable Income (\$Millions)	Income Tax Paid (\$ Millions)
200k - 500k	547,239	134,655.95	38,446.62
500k - 1mil	114,562	67,552.23	19,040.6
1 mil +	61,896	150,744.78	42,254.82
	723,697	352,952.98	99,742.02

Fig 6. Living Standards far Above Western Europe

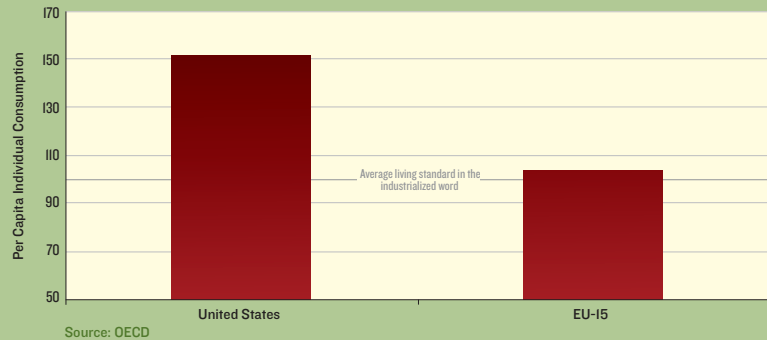
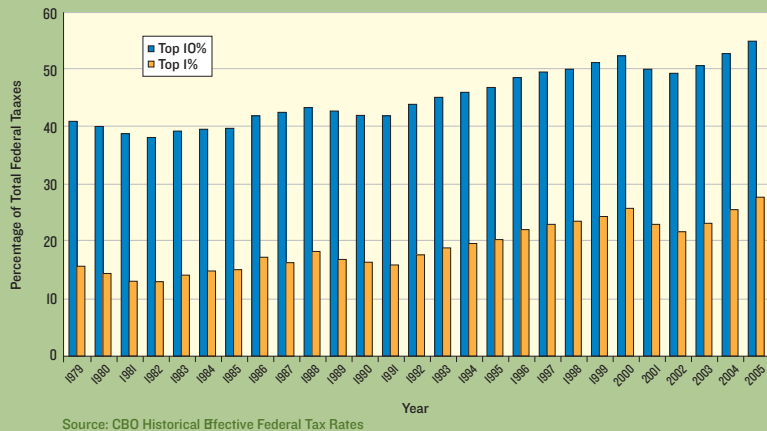


Fig 7. Tax Burden





## HIGH TAX RATES ON THE RICH WON'T HELP THE POOR —OR ANY OTHER SEGMENTS OF THE POPULATION.

The class-warfare crowd often argues that higher tax rates are needed to help the less fortunate, but they rarely provide any evidence for this assertion. Imposing punitive tax rates may be an effective way of punishing the rich (and making it more difficult for other people to become rich), but this means lost output for the economy. Some honest class warfare proponents admit the economy will be less prosperous, but they assert that slower growth is an acceptable price to pay since the government will have some additional money to spend to help the poor. But this claim rests on a couple of rather dubious assumptions.

First, as discussed above, higher tax rates don't necessarily mean more tax revenue. Second, it assumes that bigger government actually helps poor people.

But if that is true, why don't poor people in Europe—where government is so much bigger—have higher living standards than poor people in America? Instead, the data show that the poorest 10 percent of Europeans and the poorest 10 percent of Americans have comparable living standards. For everyone else, including the near-poor, lower middle class, and above, America has a sizable advantage. As the attached chart indicates, the average per-capita consumption in America is far higher than the same measure of living standards in the advanced nations of Europe. (see *Figure 6*)

## UPPER-INCOME TAXPAYERS ALREADY PAY A HUGE SHARE OF THE TAX BURDEN.

Advocates of higher tax rates should be asked if there is a point where they will be satisfied. Should the top tax rate be increased from 35 percent to 39.6 percent, as Obama has proposed? Or should it be 50 percent? How about 70 percent, which is where it was when Reagan took office? And what share of the tax burden should the rich pay? Is it fair for the top 10 percent to shoulder 20 percent of the income tax burden? Is 40 percent the right amount? Would 60 percent be too much?

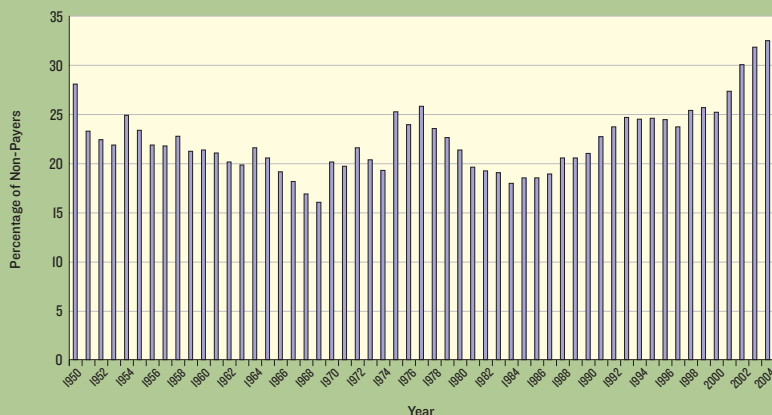
These questions are very relevant since proponents of class warfare would like voters to think that the so-called rich are lightly taxed, but the IRS data tell a different story. As the chart illustrates, the top 1 percent pay about 25 percent of all federal taxes and more than 35 percent of all federal income taxes. The top 10 percent, meanwhile, pay more than 50 percent of all federal taxes and about 70 percent of all federal income taxes. (The economic downturn, especially in financial markets, is likely to cause these numbers to fall when data for 2007 and 2008 are released.) (see *Figure 7*)

## A HUGE SHARE OF LOWER-INCOME AMERICANS PAY NO INCOME TAX.

While upper-income taxpayers finance an enormous share of government, many Americans pay nothing—or almost nothing. According to the Tax Foundation, about one-third of all taxpayers have no income tax liability. The IRS, meanwhile, reports that the bottom 40 percent of the population, measured as a group, have a negative income tax liability. This means that what little tax they pay is more than offset by the income redistribution (the so-called earned income credit) they receive through the tax system. (see *Figure 8*)

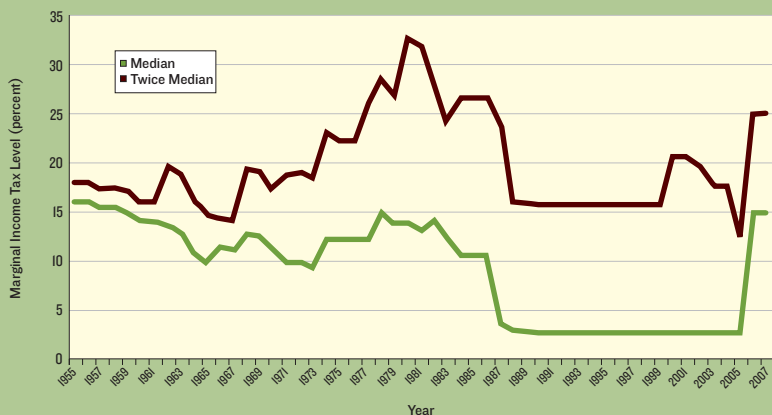
This should be a big issue, but it gets very little attention. As recently as the late 1980s, fewer than 20 percent of taxpayers escaped all federal income tax. Now the number is 33 percent, and President Obama has proposed policies that will push the number of non-payers

Fig 8. Americans Paying No Income Tax



Source: The Tax Foundation

Fig 9. Median Income v Twice Median Income Marginal Federal Tax Levels





to more than 40 percent. One danger of this approach is that people who do not pay for government are more likely to decide that bigger government is a good thing. This something-for-nothing mentality is probably among the reasons why so many European nations have become so uncompetitive. Once a majority of the population figures out how to mooch off government, it becomes very difficult for politicians to undo the damage.

**HIGH TAX RATES ON THE RICH LEAD TO HIGHER TAX RATES ON THE REST OF US.**

When the income tax was first imposed in 1913, the top rate was only 7 percent and it applied only to the top 0.5 percent of the population. Today, the tax burden on the rich is much higher, but so is the tax burden on the rest of us. What the politicians don't want people to understand is that there are not enough rich people to finance big government. So whenever they want to raise taxes on regular people, they begin the process by going after upper-income taxpayers. Their theory is that ordinary taxpayers can be tricked into accepting higher taxes if their better-off neighbors are getting hit even harder. Unfortunately, the only winners in that game are the politicians.

The chart on Page 33 shows how this works. The tax rate on the average household is strongly correlated with the tax rate on households that have twice as much income, which demonstrates that regular people pay more when their more successful neighbors pay more (there also is a relationship between the average tax rate and the official top tax rate, but it is not quite as obvious because of the interaction of tax rates, tax loopholes and tax planning). (see Figure 9 on Page 33)

The moral of the story is that upper-income taxpayers are the "canary in the coal mine" for regular taxpayers. When politicians play class warfare, regular people inevitably are next on the chopping block. •

*Daniel J. Mitchell, an expert on tax reform and supply-side tax policy, is a senior fellow at the Cato Institute.*

**THE TOWNHALL ON...**

**Taxes**

**"The tax cuts in the stimulus package will act against the spending to thwart the economic effect. Unless Congress passes tax *increases*, the country, and possibly the world, will continue to slide into a depression. Tax *increases* are necessary—no alternative. Stimulus spending alone won't salvage the disaster."**

**zoniedude**  
blogger, Daily Kos

"Our proposals are rooted in the belief that fast-acting tax relief, rather than slow-moving and wasteful government spending, is the most effective way to protect and create jobs and help put our economy back on track. They provide relief to those who need it most: middle-class families, job seekers, small businesses owners, the self-employed, entrepreneurs, and homebuyers—all with the goal of letting them keep more of what they earn and helping our economy create good-paying, long-lasting jobs."

**John Boehner**  
Townhall.com

"As a CPA, I cannot effectively advise my clients what is coming for them in the near future. I can only say, 'Watch your wallets; there is more going to the government.' So much for us getting a stimulus."

**Bruce Bialosky**  
Townhall.com

