BARRON'S

Surprise! The 1% Are Paying Their Fair Share

By GENE EPSTEIN

President Obama says, "If you make more than $1 million a year, you should not pay less than 30% in taxes." Data on the top 1% show that the "fairness" rule already applies.

Call them the Fantastic Four. Only four taxpayers have the distinction of making the Internal Revenue Service's anonymous list of the 400 highest-income filers in every one of the 17 years (1992-2008) for which the IRS has collected such data. Just 27% of the wealthiest filers have made the top-400 list more than once, and just 15% more than twice.

Even a one-time trip through this gilded door is surely a thrill, however. In 2008, entry into the favored 400 required a minimum adjusted gross income of $109.7 million, down from a cutoff of $138.8 million in '07—a decline that must have had a lot to do with the fall in asset prices. We can infer that from another striking fact: A disproportionate 57% of AGI for the top 400 came from capital gains in '08, down from 66% in '07.

The revolving door for the über-rich has been noted in other research. Setting $1 million in pretax income as the threshold, the Tax Foundation, a research group, found that from 1999 through 2007, "roughly half of millionaires were only millionaires once during the nine-year period," and "only 6% were millionaires in all nine years," with capital gains also accounting for an outsize share of income.

We might note that a "millionaire" used to be a person with a net worth of a million dollars, but that was many inflations ago. It turns out that a lot less than $1 million a year is required for entry into the much-reviled top 1%.

The most comprehensive figures come from the nonpartisan Congressional Budget Office, again using IRS data. Entry into the top 1% of income-tax filers—1.4 million households against a total of about 140 million—required a "minimum adjusted income" of $350,000 in 2007, the most recent year for which data are available, a cutoff that might be no higher in 2012, given the decline in asset prices.

The CBO figures offer a close look at trends in tax burdens, defined as taxes paid taken as a percentage of income. The chart below compares the effective tax rates for different income classes in 1979-80, just before the Reagan tax cuts of 1981, with those in 2006-07, several years after the George W. Bush tax cuts of 2001.

Two related conclusions can be drawn from the data. First, the decline in the effective tax rate has been approximately the same, in proportionate terms, across all income classes. Second, the progressivity of the tax burden across income classes was about the same in 2006-07 as it was in 1979-80.

Yet one shouldn't view these income classes as representing the same people from one period to the next. As Chris Edwards, the Cato Institute's editor of DownsizingGovernment.org, points out, "There is no permanent aristocracy at the top end of the income spectrum."

When President Barack Obama articulated this key tenet of his tax-fairness doctrine—"If you make more than $1 million a year, you should not pay less than 30% in taxes"—it raised the question of whether such a permanent aristocracy existed. What if, as the data indicate, when you make a million dollars one year, your chances of making a million the next year are just 50-50?

Then, perhaps, your great years might be averaged with your less-great, a principle that used to be recognized in the "income averaging" provisions of the tax code, abolished for most taxpayers by the Tax Reform Act of 1986.

Maybe income averaging deserves a comeback.

MEANWHILE, AS THE CHART shows, President Obama's 30% fairness rule does indeed apply to the top 1%, although not in the sense he meant.

The effective income-tax rate on the top 1% has declined, from 22.1% in 1979-80 to 19% in 2006-07. But the income tax is not the only way the federal government raises revenue through taxes. And since institutions don't pay taxes, only people do, the CBO has estimated the share of these other taxes, including the tax on corporate income.

According to CBO estimates, if you add the share paid by the top 1% of the federal government's payroll, excise, and corporate income taxes, the effective burden on the top 1% comes to 30.4% in 2006-07, down from 35.8% in 1979-80.

The corporate income tax is quite progressive, based on the CBO's plausible assumption that corporate taxes are paid by shareholders. The top 1% paid 9.7% of income in corporate taxes in 2006-07, compared with 5% for the top 20% and 1.2% for the next-highest 20%.

Similarly, it has been pointed out that, if Warren Buffett were to include the tax he effectively pays as principal shareholder of Berkshire Hathaway, he would be paying a much higher tax as a share of income than he has publicly admitted to—and certainly more than that of his now-famous secretary.

The other two taxes cut in the other direction. The excise tax, imposed on such items as fuel, tobacco, and alcohol, is a regressive tax, taking a larger percentage share of the income of the bottom 20% than of the top 1%.

The payroll tax, the one tax that has risen since 1979, is also regressive.

THAT REGRESSIVITY RESULTS not just from the fact that most of the payroll tax applies to the first $100,000 of wages and salaries ($110,100 in 2012). It's also because so much of the income earned by the wealthy comes not from wages and salaries, but from investment income.

The CBO makes the plausible assumption that the employers' share of the payroll tax is effectively paid by the employee—"passed on to the employees in the form of lower wages." As a result, the burden of the payroll tax is actually higher than the income tax for all income groups except the top 20% and 1%.

But even after the excise and payroll taxes are added, the progressivity of the effective taxes remains. One can quarrel with the claim that progressivity has not changed very much over this period. It is certainly true that a one-percentage-point decline in the tax burden is worth far more in sheer dollars to a taxpayer in the top 20% than in the bottom 20%. But in terms of the way the distribution of income is normally calculated, the CBO seems right to conclude that the "impact of federal taxes on the distribution of income" has been "relatively small."

The estate tax, also quite progressive, is not included in these figures. And as the chart shows, the decline in the income tax for the bottom 40% actually went from a small positive to a negative, ever since outright cash payments from the IRS began to exceed taxes paid.

Considering the huge and persistent federal deficit, all these taxes are too low.

But before we decide the remedy lies in raising taxes across the board, we might consider whether federal spending itself is too high. Just for starters, as Chris Edwards of DownsizingGovernment.org points out, billions of dollars in farm subsidies go to the already-rich. How many of these lucky recipients are occasionally found in the top 1%? A fruitful area of inquiry.