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The Path To Tax Reform: Cutting Taxes For Those Who Pay For Them

The famed fiscal cliff looms. The Bush administration income tax cuts expire at the end of the year, along with the Obama payroll tax reduction. Congress should extend all of the cuts rather than play the socially destructive game of class warfare.

The U.S. faces a fiscal crisis. However, it is a crisis of spending. Outlays have exploded under both Presidents George W. Bush and **Barack Obama**. Domestic and military expenditures are up dramatically. Today spending accounts for an abnormally high percentage of the GDP.

However, President Obama remains fixated on increasing taxes. No doubt, one reason is the traditional leftish enthusiasm for bigger government. In general, the more one taxes the more one can spend.

Uncle Sam has primarily paid for his recent explosion of outlays with a tsunami of debt—more than \$1 trillion in red ink in each of the last four years. But with the American people growing more concerned about incessant borrowing, higher taxes have become an imperative to continue funding the expansive and expensive welfare/warfare state.

Taxes also offer a means for Democrats to play their traditional class war card. Seeking reelection in the midst of difficult economic times, the president would prefer to talk about anything other than economic growth and unemployment. Hence President Obama's insistence that Congress allow tax cuts to expire for the "rich."

The wealthy always have been a convenient political target. A recent Pew Research Center poll found that 58 percent of Americans believe the rich don't pay enough in taxes. This sentiment animates would-be class warriors. "I'm not proposing anything radical here," argued the president: "I just believe that anybody making more than \$250,000 a year should go back to the income-tax rates we were paying under **Bill Clinton**." (In fact, the president's health care bill imposed a 3.8 percent investment income surcharge on high earners, so rates would be higher.)

However, most Americans are not moved by the appeal to envy. An overwhelming 68 percent believe it is “important” to extend all of the Bush tax cuts, including for those earning above \$250,000.

President Obama professes shock over the “cost” of tax cuts. The AFL-CIO complains of “tax giveaways.” However, tax cuts are not a government expenditure but a return of tax payments. Tax cuts are not transferring income, taking money from Peter to pay Paul and the latter’s lobbyists, but returning money previously earned, giving Paul what originally was Paul’s.

As a result, the rich normally receive more than the poor in tax cuts because the former pay more in taxes. Indeed, the wealthy pay a lot more in taxes. So any fair tax cut gives more money back to the rich than the poor. Presidential spokesman Robert Gibbs said that “millionaires, billionaires, they don’t need a tax cut.” But the issue is justice. In contrast, “tax cuts” which give money to those who don’t pay taxes are welfare, not tax cuts.

Mere possession of wealth does not justify confiscation by the state, or even high tax rates. A government which ensures a secure and free society operating under a rule of law warrants support. However, these conditions benefit everyone, irrespective of income. There’s no reason in principle to prefer progressive to proportional taxation, other than the natural desire of the majority to shift the cost of government onto someone else. And politicians have no legitimate claim to an unlimited share of other people’s money, whether they are rich or poor.

Moreover, the rich already pay a disproportionate share of taxes. According to a recent study by the Congressional Budget Office, the top one percent of earners pays 22.3 percent of income taxes and an average rate of 28.9 percent. The next four percent pays 17.3 percent of income taxes and an average rate of 24.1 percent.

The top income quintile pays 67.9 percent of income taxes and an average rate of 23.2 percent. The second quintile accounts for 18.3 percent and pays an average rate of 15.1 percent. The middle quintile pays 9.4 percent and an average rate of 11.1 percent. Quintile number four pays 3.8 percent of total collections and an average rate of 6.8 percent. The bottom quintile pays .3 percent of tax collections and an average rate of 1.0 percent.

The only group which pays more than their proportional share is top earners. Everyone else comes in under average.

Moreover, the rich pay a higher share than their share of income. The top quintile accounts for 50.8 percent of before tax and 47.2 percent of after tax income. The respective numbers for the next quintile are 21.1 and 21.6. The middle quintile comes in at 14.7 and 15.8 percent. The fourth quintile is 9.8 and 11.1 percent. And the lowest quintile is 5.1 and 6.2 percent. Noteworthy is the income

impact of taxes: under the current system, only high earners end up with a smaller share of total income after taxes. Everyone else gains share.

The differences in shares of income taxes paid are particularly dramatic. The respective quintile shares are 94.1 percent, 13.1 percent, 2.7 percent, -3.5 percent, and -6.6 percent. That is, the bottom 40 percent of Americans collect more through income tax credits than they make in income tax payments.

Other analyses offer equally striking results. The top one percent of earners pays 36.7 percent of all income taxes collected. The top five percent pays 58.7 percent. The top ten percent pays 70.5 percent. The top quarter pays 87.3 percent. The top half pays 97.8 percent. Which means that the poorest half of the population pays virtually no income taxes. (The average tax rate paid by the bottom two quintiles actually is negative, 9.3 percent and 2.6 percent, due to refundable tax credits, especially the earned income tax credit.)

No surprise, the wealthy also pay a disproportionate share of corporate taxes. The shares per quintile, respectively, are 77.2, 10.2, 5.8, 3.2, and 1.8 percent.

Class warriors point to payroll taxes, but these levies make “much less difference than people might think,” noted Stephen Moore of the *Wall Street Journal* in a new study for the *Manhattan* Institute. Anyway, high earners also pay the largest share of social insurance taxes, though their share is not so disproportionate. The top quintile accounts for 45.3 percent, compared to 24 percent for the next quintile, 15.4 percent for the middle quintile, 9.7 percent for the fourth quintile, and 5.3 percent for the bottom quintile. Even excise taxes, which are imposed with no relationship to income, are paid disproportionately by the wealthy, though the numbers are closer: 32.1, 21.3, 18.8, 15.1, and 12.2 percent.

Overall, Moore argued that it is a myth “When all the other taxes are counted, the rich get off easy.” Scott Hodge, president of the Tax Foundation, figured that the U.S. takes a higher share of the earnings of the wealthy than any other wealthy industrialized state. He explained: “the U.S. has the most progressive income tax system among industrialized nations.”

America’s top ten percent of taxpayers account for 45 percent of all collections, 50 percent above the 32 percent average for the Organization for Economic Cooperation and Development (industrialized) states. In contrast, the wealthiest ten percent of taxpayers pay 42 percent in Italy, 39 percent in Great Britain, and 37 percent in Australia. The comparable numbers are just 28 percent in France, 27 percent in Sweden, and 21 percent in Switzerland.

Of course, one still could believe that the rich should pay more. But not because they aren’t paying their “fair” share, whatever that means.

President Obama also contended that “We can’t afford to keep” up tax cuts for those earning above \$250,000. However, higher tax rates create a disincentive to work and invest. Wealthier taxpayers are likely to choose consumption activities and tax shelters in response to rising taxes. Tax cuts may not literally pay for themselves, at least when the rates are at today’s levels (going from 100 percent to 90 percent clearly would raise revenue; going from 10 percent to 0 percent equally obviously would not; in between is an empirical question). However, static estimates always overstate lost revenue. Moore reported that past rate reductions “brought in more money because they helped the economy to grow and created more jobs and more wealth.”

Further, there are two sides of every deficit: spending as well as taxing. It isn’t possible to sustain America’s modern welfare/warfare state only through taxes on the rich. And it wouldn’t be fair if it was possible.

In fact, “we can’t afford” today’s policies because we are spending too much, not because we are taxing too little. Social Security and Medicare are middle class welfare, fake social insurance in which the young subsidize the old. ObamaCare will inflate demand for health care, inflating federal expenses. The bulk of U.S. military outlays go to protecting prosperous and populous allies, rebuilding failed societies, and making other nations’ conflicts our own. Corporate welfare underwrites profit-making firms. None of these expenditures warrant higher taxes on anyone, rich or poor.

Before they think, let alone talk, about raising taxes Congress and the president should cut spending. Even a passionate liberal/progressive should take a hard look at Uncle Sam’s \$3.6 trillion in outlays. Policymakers should assess effectiveness, eliminate duplication, rethink priorities, and make trade-offs. Until they do so, there is no serious argument for raising taxes.

The GOP should not stop with supporting the Bush tax cuts. So far Republicans say they have no interest in extending the two percentage point payroll tax cut, leaving them open to attack—already launched by Senate Majority Leader Harry Reid—for favoring wealthier Americans with tax reductions. Ironically, the administration also is not pressing to maintain the payroll cut. Jason Furman of the president’s National Economic Council explained: “That was always intended to be a temporary measure to support job creation and economic growth.”

The GOP is missing an opportunity to highlight the fact that Social Security is not social insurance, that payroll taxes are not the equivalent of private IRA contributions. “I don’t think we can keep cutting into Social Security,” said House Speaker John Boehner. Yet program benefits will be paid irrespective of payroll tax levels. Barry Rand, AARP’s CEO, complained that an extension would “put at risk Social Security’s dedicated funding stream and the hard-earned benefits of

millions of Americans and their families.” However, the tension between taxpayers and retirees must be addressed, the sooner the better.

Taxes should be simplified as well as reduced. A revenue code of 72,000 pages invites abuse. “Tax expenditures”—special interest exemptions from general tax obligations—have become a prime tool for enriching the influential. Slipping an obscure tax provision into a large bill hides expenditures which would be embarrassing if provided through a direct appropriation. Bloomberg columnist Caroline Baum complained: “The rich employ people to lobby Congress on behalf of their particular business or industry. They make large campaign contributions to committee chairman, who might be persuaded to craft a specific tax break or vote in a certain way on a piece of legislation. And they hire tax consultants and lawyers to walk them through the maze of loopholes, shelters and strategies to shift income and reduce the estate-tax burden on their heirs.” The president, who has declared himself for reform, and Congress should simplify taxes before arguing for increased rates.

Finally, government employees who make and enforce the tax law should pay what they owe. Earlier this year the IRS reported that federal workers owe \$3.4 billion in back taxes. The IRS cited 36 White House aides who owe \$833,970 in back taxes. An even more astounding 1,181 Treasury Department employees, who are in charge of federal finances and taxes, owe \$9.3 million. (At least Timothy Geithner paid up after being nominated as Treasury Secretary.) Worse, 2,069 staffers at the Department of Justice, which enforces the law, owe almost \$17 million. The same problem exists on Capitol Hill, where tax law is made. House staffers owe \$8.5 million; Senate employees owe \$2.1 million.

Taxes should be lower, simpler, and fairer. In the short-term Congress should extend the Bush tax cuts as well as the payroll tax reduction. Over the long-term Congress should enact fundamental tax reform. However, fixing the tax system will be near impossible as long as federal spending is out-of-control. The basis for tax reform is spending reform. Shrinking the federal Leviathan should be the most important election issue for November.