Higher Tax Rates On Rich Won't Increase Revenues

By ALAN REYNOLDS
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In last week's campaign speech disguised as an address to Congress, President Obama said, "Warren Buffett pays a lower tax rate than his secretary — an outrage he has asked us to fix."

Writing recently in The New York Times, the famed chairman of Berkshire Hathaway complained that his federal income tax last year was "only 17.4% of my taxable income" — less than $7 million on a taxable income of about $40 million.

Buffett claimed that, like himself, other "mega-rich pay income taxes at a rate of 15% on most of their earnings," but that is not at all common. The average income-tax rate of those earning between $1 million and $10 million was 29.5% in 2009.

Obama used Buffett's uniquely low 17.4% tax as proof that "a few of the most affluent citizens and most profitable corporations enjoy tax breaks and loopholes that nobody else gets." That is not true.

Anyone whose income is almost entirely composed of realized capital gains or dividends would "pay income taxes at a rate of 15% on most of their earning." Investors with modest incomes also pay a tax rate of 15% on dividends and capital gains, although that rate is scheduled to rise to 18.8% under the Obama health law (and much higher if Congress enacted the "reforms" Obama will propose next Monday).

Before 2003, when the tax on dividends was made the same as the tax on capital gains, Berkshire Hathaway was a handy tax dodge — a way to own dividend-paying stocks without paying taxes on the dividends. Buffett is famous for collecting stocks with a generous dividend yield without Berkshire itself paying any dividend.

The dividends Berkshire receives are reinvested in buying more stocks, so the holding company ends up with more assets per share which results in capital gains that would be taxable only if the shares are sold.

Warren Buffett is the second wealthiest person in America, but he reports surprisingly little taxable income for someone who owns more than $50 billion of Berkshire shares. Increasing the tax rate on salaries and interest income would barely affect him.

He pays himself a salary of just $100,000, which explains how he pays less than his employees do in payroll taxes. He dodged the estate tax by donating his wealth to the Bill and Melinda Gates Foundation. He doubtless reduces his taxable income with other donations to charity, which explains why he repeatedly refers to taxable income rather than adjusted gross income.

Mr. Buffett ends by appointing himself tax czar and declares he "would raise rates immediately on taxable income in excess of $1 million, including, of course, dividends and capital gains. And for those who make $10 million or more ... (he) would suggest an additional increase in rate."

Since he only reports $100,000 of salary, he has nothing to lose by advocating a higher tax rate on salaries. Nearly all of his income in 2010 consisted of capital gains on sales of Berkshire shares, because those shares pay no dividends. But Buffett could just as easily hang onto appreciated shares rather than selling them, or he could donate them to charity.

Raising tax rates on dividends and capital gains sounds easier than it is. Nobody with substantial wealth can be forced to realize taxable gains by selling appreciated assets. A realized gain is no more valuable than an unrealized gain. On the contrary, it is less valuable by the amount of the tax.

Nobody can be forced to hold dividend-paying stocks either. They can instead buy Berkshire Hathaway shares if the tax on dividends goes up, as Buffett understands.

Despite his personal and professional dependence on capital gains, Buffett nevertheless feigns total ignorance of who pays the capital gains tax and why. He says, "I have worked with investors for 60 years and I have yet to see anyone — not even when capital gains rates were 39.9% in 1976-77 — shy away from a sensible investment because of the tax rate on the potential gain."

Well, the Dow Jones industrial average was 831 at the end of 1977 — down from 969 at the end of 1965 — so somebody was having trouble finding investments that would still look sensible after paying a 39.9% tax.

In any case, for Buffett to focus on the act of buying stocks or property is all wrong. The capital gains tax is not a tax on buying assets. It is a tax on selling assets. If you don't sell, there is no tax. And when the capital gains tax is high, very few people are willing to sell.

In 1977, when the capital gains tax was 39.9%, realized gains amounted to less than 1.57% of GDP. From 1987 to 1996, when the capital gains tax was 28%, realized gains rose to 2.3% of GDP. Since 28% of 2.3 is larger than 39.9% of 1.57, the lower tax rate clearly raised more tax revenue.

From 2004 to 2007, when the capital gains tax was 15%, realized gains amounted to 5.2% of GDP. Since 15% of 5.2 is larger than 28% of 2.3, the lower tax rate again raised

more tax revenue. The government cannot afford to raise this tax, particularly on those most likely to pay it.

Buffett focuses on the 400 tax returns with the highest reported incomes, which are often one-time capital gains from the sale of a business or real estate.

"In 1992," he writes, "the top 400 had aggregate taxable income of $16.9 billion and paid federal taxes of 29.2% on that sum. In 2008, the aggregate income of the highest 400 had soared to $90.9 billion — a staggering $227.4 million on average — but the rate paid had fallen to 21.5%."

In 1992 only 39% of reported income of the top 400 came from capital gains and dividends because those tax rates were so high. With most reported income coming from salaries, the average tax rate was high.

By 2008, 67% of reported income of the top 400 came from capital gains and dividends because both were taxed at 15%. That diluted the average tax rate, yet nevertheless resulted in much more taxes paid because the amount of reported income was so much larger.

The big change was not in actual income, but merely in what the IRS counts as income. People were hiding more of their wealth in 1992 than they did in 2006-2008, and they were hiding even more in 1977.

It is easy to advocate a higher tax rate on capital gains, but it is even easier to avoid paying that higher tax rate. Simply hold onto assets that went up and sell those that went down, and never realize gains until you have offsetting losses.

The evidence is undeniable that affluent investors and property owners report far fewer gains whenever the capital gains tax goes up. Choosing to pay tax on capital gains and dividends is usually voluntary, and when the rate gets too high we run short of volunteers.

With the super-high 1977 tax rates of 39.9% on capital gains and 70% on dividends and salaries, federal revenues were 18% of GDP. In 1992, revenues were only 17.5% of GDP. In 2007, thanks in large part to a 15% tax rate on capital gains and dividends, revenues were 18.5% of GDP.

To hold out the tax policies of 1977 or 1992 as examples of effective ways to raise more revenue is ludicrous. It didn't work then, and it wouldn't work now.

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