THE WALL STREET JOURNAL.

DECEMBER 6, 2011

Tax Rates, Inequality and the 1%

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By ALAN REYNOLDS

A recent report from the Congressional Budget Office (CB0) says, "The share of income received by the top 1% grew from about 8% in 1979 to over 17% in 2007."

This news caused quite a stir, feeding the left's obsession with inequality. Washington Post columnist Eugene Robinson, for example, said this "jaw-dropping report" shows "why the Occupy Wall Street protests have struck such a nerve." The New York Times opined that the study is "likely to have a major impact on the debate in Congress over the fairness of federal tax and spending policies."

But here's a question: Why did the report stop at 2007? The CBO didn't say, although its report briefly acknowledged—in a footnote—that "high income taxpayers had especially large declines in adjusted gross income between 2007 and 2009."

No kidding. Once these two years are brought into the picture, the share of after-tax income of the top 1% by my estimate fell to 11.3% in 2009 from the 17.3% that the CBO reported for 2007.

The larger truth is that recessions always destroy wealth and small business incomes at the top. Perhaps those who obsess over income shares should welcome stock market crashes and deep recessions because such calamities invariably reduce "inequality." Of course, the same recessions also increase poverty and unemployment.

The latest cyclical destruction of top incomes has been unusually deep and persistent, because fully 43.7% of top earners' incomes in 2007 were from capital gains, dividends and interest, with another 17.1% from small business. Since 2007, capital gains on stocks and real estate have often turned to losses, dividends on financial stocks were slashed, interest income nearly disappeared, and many small businesses remain unprofitable.

The incomes that top earners report to the IRS have long been tightly linked to the ups and downs of capital gains. Changes in the tax law in 1986, for example, evoked a remarkable response—with capital gains accounting for an extraordinary 47.7% of top earners' reported income as investors rushed to cash in gains before the capital gains tax rose to 28%.

That was obviously temporary, but the subsequent slowdown in realized gains lasted a decade. Taxable gains accounted for only 16.7% of the top earners' income between 1987 and 1996. And the paucity of realized capital gains kept the top earners' share of income flat.

When the top capital gains tax fell to 20% in 1997 and remained there until 2002, realized capital gains rose to 25.4% of the top earners' income, and it explained much of the surge of their income share to 15.5% in 2000. Stock gains were more modest from 2003 to 2007, yet the tax rate on profitable trades was down to 15%, so realized capital gains rose to 26.7% of income reported by the top 1%.

True enough, capital gains are not the whole story, and the CBO's report, "Trends in the Distribution of Household Income Between 1979 and 2007," notes that "business income was the fastest growing source of income for the top 1 percent." But that too was a behavioral response to lower tax rates.

In 1988, business income jumped to 16.5% of the reported income of the top 1%, from 8.2% in 1986. Why? As the CBO explains, "many C corporations . . . were converted to S corporations which pass corporate income through to their shareholders where it is taxed under the individual income tax."

The CBO estimates top incomes from individual tax returns. So it looked like a big spurt in top income in 1988 when thousands of businesses switched to reporting income on individual rather than corporate returns as the top individual tax rate dropped to 28% from 50%.

In reality, it was just a switching between tax forms to take advantage of the lower individual tax rate. Such tax-induced switching from corporate to individual tax forms in 1986-1988 makes it illegitimate to compare top income shares between 1979 and 2007.

After the tax rate on dividends fell to 15% in 2003 from 35%, the share of income reported by top earners from dividends doubled to 8.4% in 2007 from 4.2% in 2002, according to similar tax-based estimates from economists Thomas Piketty and Emmanuel Saez. Top earners held more dividend-paying stocks in taxable accounts rather than in tax-exempt bonds, or they kept dividends in tax-free retirement accounts.

In short, what the Congressional Budget Office presents as increased inequality from 2003 to 2007 was actually evidence that the top 1% of earners report more taxable income when tax rates are reduced on dividends, capital gains and businesses filing under the individual tax code.

If Congress raises top individual tax rates much above the corporate rate, many billions in business income would rapidly vanish from the individual tax returns the CBO uses to measure the income of the top 1%. Small businesses and professionals would revert to reporting most income on corporate tax returns as they did in 1979.

If Congress raises top tax rates on capital gains and dividends, the highest income earners would report less income from capital gains and dividends and hold more tax-exempt bonds. Such tax policies would reduce the share of reported income of the top earners almost as effectively as the recession the policies would likely provoke. The top 1% would then pay a much smaller portion of federal income taxes, just as they did in 1979. And the other 99% would pay more. As the CBO found, "the federal income tax was notably more progressive in 2007 than in 1979."