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With His Tax Proposals, Warren Buffett Flunks Economics 101

By Swaminathan Aiyar – December 2nd, 2012

Warren Buffett, in a New York Times op-ed, renewed his call for a minimum income tax of 30% on the wealthy to block them from taking advantage of concessional tax rates for dividends and capital gains, or seeking other tax shelters. He seems unaware that our tax laws distort the definition of "income" to something utterly different from income as defined in

Basic economics textbooks tell you that income is value addition–the difference between the value of output and the inputs going into it. Any production process uses three inputs— labor, land and capital. Returns to labor are called salaries and wages, returns to land are rents, and returns to capital are profits. All true income belongs to these three categories.

Some items commonly called income are actually transfers in Economics 101, since they do not add any value. Alimony to an ex-spouse may seem like income to the recipient, but is actually just a transfer. So is the kids' allowance. So are welfare payments and business subsidies. So too are dividends.

When a corporation makes profits, they represent value added, and constitute income on which the corporation pays taxes. But when a corporation distributes part of its post-tax profits to shareholders, this is a transfer. When Warren Buffett sees millions flowing into his bank accounts as dividends, he (and the taxman) may call them income, but in Economics 101 they are merely transfers.

Are you claiming, critics will sneer, that a billionaire living solely on millions from dividends has no income at all? Well, no. The billionaire is part owner of companies that earn profits, and his true income is his share of those profits. The taxman calls these corporate income, not individual income, but we must look behind the corporate veil. Corporations are simply groups of individuals and institutions like pension funds representing individuals. Economics 101 tells us that our billionaire's true income is not the dividends he receives but his share of corporate profits.

Seen in this light, Buffett's true income and true taxes paid are far higher than then figure in his tax returns. His true income includes his proportionate share of corporate profits, not of dividends. His true tax payments include a proportionate share of the corporate tax paid by the companies in which he has shares.

Taxing transfers (like dividends) amounts to double taxation. The IRS first taxes profits earned by a corporation, and again taxes the proportion of profits distributed as dividends. Asking whether a fair tax rate for dividends is 15 percent or 30 percent misses the point that any double taxation at all is unfair. In principle, taxing dividends is no different from taxing the allowance you give to your kids, which is also a transfer.

Capital gains are not income either as defined in Economics 101. If you sell part of your portfolio and re-invest it in other shares, you are simply churning your portfolio, not creating income (value addition) as defined in Economics 101. Yet the IRS will tax you on this churning to the extent that any stock was sold at a higher price than it was bought. Somebody who does not churn his portfolio can register huge gains and yet not be taxed: IRA levies the tax only when you churn your portfolio.

Now, portfolio churning is an act of diligence and prudence, and this should surely be encouraged rather than taxed. Fund managers are paid large sums to churn portfolios to try and maximize gains for their clients. A fund manager who doesn't churn his portfolio at all will be sacked for gross neglect of fiduciary responsibility. Yet when an individual churns his portfolio, the IRS, far from applauding the individual's diligence, taxes it.

Apologists for the capital gains tax say that when an asset is sold, the capital gain is converted to cash and can be viewed as an income flow. But there is no net cash at all if the sale proceeds are re-invested in fresh assets, yet the IRS will insist on levying a tax. Clearly the tax relates not to free cash but to portfolio churning.

Warren Buffett needs to go back and re-assess his income and taxes in the light of Economics 101. He will find he is paying taxes on transfers and portfolio churns that are not really income at all. Strip these out, and his tax rate will surely be higher than his secretary's.