Increasing Tax Rates on Top 1% Would Make Tax System Less *Progressive*

Wall Street Journal op-ed, **Taxes and the Top Percentile Myth**, by **Alan Reynolds** (Cato Institute):

[T]he left wing of the Democratic Party remains passionate about making the U.S. tax system more and more progressive. ... Arguments for these retaliatory tax penalties invariably begin with **estimates** by economists Thomas Piketty of the Paris School of Economics and Emmanuel Saez of U.C. Berkeley that the wealthiest 1% of U.S. households now take home more than 20% of all household income. This estimate suffers two obvious and fatal flaws.

The first is that the "more than 20%" figure does not refer to "take home" income at all. It refers to income before taxes (including capital gains) as a share of income before transfers. Such figures tell us nothing about whether the top percentile pays too much or too little in income taxes. In **The Journal of Economic Perspectives** (Winter 2007), Messrs. Piketty and Saez estimated that "the upper 1% of the income distribution earned 19.6% of total income before tax [in 2004], and paid 41% of the individual federal income tax." No other major country is so dependent on so few taxpayers. A 2008 **study** of 24 leading economies by the OECD concludes that, "Taxation is most progressively distributed in the United States, probably reflecting the greater role played there by refundable tax credits, such as the Earned Income Tax Credit and the Child Tax Credit. . . . Taxes tend to be least progressive in the Nordic countries (notably, Sweden), France and Switzerland."

A second fatal flaw is that the large share of income reported by the upper 1% is largely a consequence of lower tax rates. In a **2010 paper on top incomes** co-authored with Anthony Atkinson of Nuffield College, Messrs. Piketty and Saez note that "higher top marginal tax rates can reduce top reported earnings." They say "all studies" agree that higher "top marginal tax rates do seem to negatively affect top income shares." What appears to be an increase in top incomes reported on individual tax returns is often just a predictable taxpayer reaction to lower tax rates. That should be readily apparent from the nearby table, which uses data from Messrs. Piketty and Saez to break down the real incomes of the top 1% by source: ...

The Income of the Rich Shifts as Tax Rates Change

Sources of the top one percent's pre-tax income, average in 2008 dollars

	Salary	Capital Gains	Dividends	Business Income
1999	$515,268	320,128	38,998	216,562
2000	551,873	389,986	43,799	216,369
2001	491,861	200,314	33,482	211,253
2002	446,953	145,433	30,673	200,107
2003	440,521	173,162	38,052	202,698
2004	474,515	259,427	52,814	230,757
2005	492,790	342,275	59,351	277,869
2006	505,874	381,352	69,971	284,613
2007	513,438	427,930	83,072	273,941
2008	504,402	232,114	67,918	256,276

Source: Alan Reynolds based on Piketty and Saez data

The first column ("salaries") shows average labor income among the top 1% reported on W2 forms—from salaries, bonuses and exercised stock options. ... [T]the table shows that average real pay among the top 1% was no higher at the 2007 peak than it had been in 1999. ...

The second column ... shows that the top 1% reported fewer capital gains in the tech-stock euphoria of 1999-2000 (when the tax rate was 20%) than during the middling market of 2006-2007 [when the tax rate was 15%]. ...

The third column shows a near tripling of average dividend income from 2002 to 2007. That can only be explained as a behavioral response to the sharp reduction in top tax rates on dividends, to 15% from 38.6%. ...

The last column of the table shows average business income reported on the top 1% of individual tax returns by subchapter S corporations, partnerships, proprietorships and many limited liability companies. After the individual tax rate was brought down to the level of the corporate tax rate in 2003, business income reported on individual tax returns became quite large. ...

[I]f tax rates on high incomes, capital gains and dividends were increased in 2013, the top 1%'s reported share of before-tax income would indeed go way down. ... Once higher tax rates cause the top 1% to report less income, then top taxpayers would likely pay a much smaller share of taxes, just as they do in, say, France or Sweden. That would be an ironic consequence of listening to economists and journalists who form strong opinions about tax policy on the basis of an essentially irrelevant statistic about what the top 1%'s share might be if there were not taxes or transfers.

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