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Taxes and the Top Percentile Myth

A 2008 OECD study of leading economies found that 'taxation is most progressively distributed in the United States.' More so than Sweden or France.

By ALAN REYNOLDS

When President Obama announced a two-year stay of execution for taxpayers on Dec. 7, he made it clear that he intends to spend those two years campaigning for higher marginal tax rates on dividends, capital gains and salaries for couples earning more than $250,000. "I don't see how the Republicans win that argument," said the president.

Despite the deficit commission's call for tax reform with fewer tax credits and lower marginal tax rates, the left wing of the Democratic Party remains passionate about making the U.S. tax system more and more progressive. They claim this is all about payback—that raising the highest tax rates is the fair thing to do because top income groups supposedly received huge windfalls from the Bush tax cuts. As the headline of a Robert Creamer column in the Huffington Post put it: "The Crowd that Had the Party Should Pick up the Tab."

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.

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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 Organization of Economic Cooperation and Development (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."

The OECD study—titled "Growing Unequal?"—also found that the ratio of taxes paid to income received by the top 10% was by far the highest in the U.S., at 1.35, compared to 1.1 for France, 1.07 for Germany, 1.01 for Japan and 1.0 for Sweden (i.e., the top decile's share of Swedish taxes is the same as their share of income).

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 (excluding interest income and rent).

The first column ("salaries") shows average labor income among the top 1% reported on W2 forms—from salaries, bonuses and exercised stock options. A Dec. 13 New York Times article, citing Messrs. Piketty and Saez, claims, "A big reason for the huge gains at the top is the outsize pay of executives, bankers and traders." On the contrary, the table shows that average real pay among the top 1% was no higher at the 2007 peak than it had been in 1999.

In a January 2008 New York Times article, Austan Goolsbee (now chairman of the President's Council of Economic Advisers) claimed that "average real salaries (subtracting inflation) for the top 1% of earners . . . have been growing rapidly regardless of what happened to tax rates." On the contrary, the top 1% did report higher salaries after the mid-2003 reduction in top tax rates, but not by enough to offset losses of the previous three years. By examining the sources of income Mr. Goolsbee chose to ignore—dividends, capital gains and business income—a powerful taxpayer response to changing tax rates becomes quite clear.

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 second column, for example, shows real capital gains reported in taxable accounts. President Obama proposes raising the capital gains tax to 20% on top incomes after the two-year reprieve is over. Yet the chart 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. It is doubtful so many gains would have been reported in 2006-2007 if the tax rate had been 20%. Lower tax rates on capital gains increase the frequency of asset sales and thus result in more taxable capital gains on tax returns.

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%.

Raising the dividend tax to 20% could easily yield no additional revenue if it resulted in high-income investors holding fewer dividend- paying stocks and more corporations using stock buybacks rather than dividends to reward stockholders.

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. For the Obama team to argue that higher taxes on individual incomes would have little impact on business denies these facts.

If individual tax rates were once again pushed above corporate rates, some firms, farms and professionals would switch to reporting income on corporate tax forms to shelter retained earnings. As with dividends and capital gains, this is another reason that estimated revenues from higher tax rates are unbelievable.

The Piketty and Saez estimates are irrelevant to questions about income distribution because they exclude taxes and transfers. What those figures do show, however, is that if 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. That would be partly because of reduced effort, investment and entrepreneurship. Yet simpler ways of reducing reported income can leave the after-tax income about the same (switching from dividend-paying stocks to tax-exempt bonds, or holding stocks for years).

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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