Warren Buffett's Call for Higher Taxes on the Rich

by Arthur B. Laffer, Ph.D.

January 2012

SUMMARY

- Warren Buffett's public call in the New York Times for the government to raise taxes on him and other "mega-rich" citizens is both hypocritical and dangerous.
- It is hypocritical because Buffett quite consciously shields almost the entirety of his true income from federal income taxation, and he makes clear his belief that he can do more good with his wealth than Uncle Sam.
- The call for higher tax rates is also dangerous because doing so would stifle economic growth and, depending on the severity of the hikes, could actually reduce federal revenue relative to what it otherwise would have been.

INTRODUCTION

The political season has barely begun and yet we already know that class warfare will be President Obama's key issue in the 2012 general election. The progressive intelligentsia is obsessed with tax increases on the rich to raise revenues and to achieve social justice.

High profile supporters of the president are joining the class warfare chorus. In an August New York Times op-ed, Warren Buffett asked Congress to "stop coddling the super-rich", complaining that his effective tax rate was half that of the other people in his office. He then instructed Washington to raise tax rates on millionaires and billionaires like him and retain the employee payroll tax cut on those "who need every break they can get."

Waving Warren Buffett's op-ed for all to see, President Obama has proposed a surtax on millionaires, called the "Buffett Rule." Putting aside all the oohing and ahhing over Buffett's selflessness, his effective tax rate on his true income would hardly budge if this "Buffett Rule" were applied.

What's worse, raising tax rates on the highest income earners would most likely worsen the federal budget deficit and lead to a further weakening of the economy, which would penalize everyone across the income distribution.

This having been written, Warren Buffett is uniquely situated to comment on how he and his "mega-rich" friends could materially affect Federal tax policies. As the richest or second richest American, his words have gravitas. If he really felt the way he says he does, then he could have proposed that the "coddled" billionaires who don't "fight for us in Afghanistan" could actually achieve "shared sacrifice" and significantly reduce the deficit without damaging the economy through a once and for all tax of 50% on all wealth over, say, $1 billion, including, of course, all philanthropic gifts that currently qualify for tax exemptions. But he didn't.

BUFFETT ON TAXES

The following excerpts capture the tone and substance of Buffett's August *New York Times* op-ed:

> OUR leaders have asked for "shared sacrifice." But when they did the asking, they spared me. I checked with my mega-rich friends to learn what pain they were expecting. They, too, were left untouched.
>
> While the poor and middle class fight for us in Afghanistan, and while most Americans struggle to make ends meet, we mega-rich continue to get our extraordinary tax breaks. Some of us are investment managers who earn billions from our daily labors but are allowed to classify our income as "carried interest," thereby getting a bargain 15% tax rate. Others own stock index futures for 10 minutes and have 60% of their gain taxed at 15%, as if they'd been long-term investors.
>
> Last year my federal tax bill—the income tax I paid, as well as payroll taxes paid by me and on my behalf—was $6,938,744. That sounds like a lot of money. But what I paid was only 17.4% of my taxable income—and that's actually a lower percentage than was paid by any of the other 20 people in our office. Their tax burdens ranged from 33% to 41% and averaged 36%.
>
> Back in the 1980s and 1990s, tax rates for the rich were far higher, and my percentage rate was in the middle of the pack. According to a theory I sometimes hear, I should have thrown a fit and refused to invest because of the elevated tax rates on capital gains and dividends.
>
> I didn't refuse, nor did others. 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. People invest to make money, and potential taxes have never scared them off. And to those who argue that higher rates hurt job creation, I would note that a net of nearly 40 million jobs were added between 1980 and 2000. You know what's happened since then: lower tax rates and far lower job creation.
>
> Job one for the 12 [members of the deficit super committee] is to pare down some future promises that even a rich America can't fulfill. Big money must be saved here. The 12 should then turn to the issue of revenues. I would leave rates for 99.7% of taxpayers unchanged and continue the current 2-percentage-point reduction in the employee contribution to the payroll tax. This cut helps the poor and the middle class, who need every break they can get.
>
> But for those making more than $1 million—there were 236,883 such households in 2009—I 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—there were 8,274 in 2009—I would suggest an additional increase in rate.
>
> My friends and I have been coddled long enough by a billionaire-friendly Congress. It's time for our government to get serious about shared sacrifice.

What's worse, raising tax rates on the highest income earners would most likely worsen the federal budget deficit and lead to a further weakening of the economy, which would penalize everyone across the income distribution.

BUFFETT THE MASOCHIST?

Buffett's article makes three claims, either explicit or implied: (1) Buffett's a really swell guy, willing to pony up his own money to help the cause; (2) neither he nor his "mega-rich" friends care about marginal tax rates when making investment decisions; and (3) raising tax rates on millionaires and billionaires will significantly help in solving the federal government's long-term budget woes. As we'll see, every one of these claims is wrong.

First let's tackle the underlying theme of Buffett's article (and his subsequent interviews), in which we are led to believe that the Rich Man from Omaha has been visited by the Ghost of Christmas Future and now realizes that money doesn't bring happiness. Is it really true that Buffett's proposals would result in him paying a higher effective tax rate than, say, the secretaries in his office?

Although Warren Buffett's 2010 taxable income of $40 million is a fantastic sum, it understates his actual income by more than 250 fold.

If we just focus on what Buffett wants us to see, the answer seems to be a clear "yes." Buffett states that he paid $6,938,744 in total income and payroll taxes in 2010, representing 17.4% of his taxable income. That means Buffett's taxable income was a hair under $40 million. If the government followed Buffett's advice and implemented two new tax brackets—one at $1 million and another at $10 million—with progressively higher marginal rates, and taxed realized capital gains and dividends at the same rate as wages and salaries (which Buffett seems to endorse, though it's ambiguous), then Warren Buffett would end up owing a much higher tax bill, assuming he didn't alter his behavior. Voilà, here we have a billionaire apparently willing to fall on the sword for the sake of "shared sacrifice."

There are just two problems with this analysis: It grossly understates Buffett's true income (and hence overstates his effective tax rate, with or without his proposals), and it ignores the smoking-gun evidence we have that Buffett shields his income from the government just like the supply-siders claim.

A standard definition of income is the amount of consumption one can finance, without reducing one's wealth. Equivalently, income over a certain period is consumption plus any increment in wealth. Under this definition, paychecks are of course part of income, as are interest earnings on bonds, dividends on stock, and capital gains on any assets, whether or not "realized."

Although Warren Buffett's 2010 taxable income of $40 million is a fantastic sum, it understates his actual income by more than 250 fold. According to the Congressional Budget Office,

> Its name notwithstanding, the underlying base of the U.S. income tax system departs significantly from definitions of income. Indeed, a chief difference among many reform proposals is the question of the appropriate tax base. There are two useful benchmarks. One is a tax on comprehensive income (often referred to as a Haig-Simons income tax). Comprehensive income includes all labor compensation earned during the year (regardless of whether it is actually paid or deferred) and all capital income (again, regardless of whether it is realized or not). Comprehensive income measures the additions to an individual's potential to purchase consumption items.

According to *Forbes Magazine*, Buffett's net worth rose by $10 billion in 2010 to $47 billion. That increase is an unrealized capital gain, and is part of his total income. As for the past decade, Buffett's net worth rose $21.4 billion, which means that his average total income averaged more than $2 billion per year.

Yet even these figures grossly understate Buffett's 2010 income. Buffett's gift to the Bill and Melinda Gates Foundation was worth $1.6 billion in 2010. This too should be included as part of Buffett's income. And these are just the additions to his income that we know about.

Buffett's true income in 2010 was therefore much closer to $11.6 billion rather than the $40 million figure Buffett cites in his op-ed, and hence his true effective tax rate was only 6/100ths of 1% as opposed to 17.4%. Buffett's proposal to raise taxes on the rich would not tax the vast majority of his shielded income, including either his unrealized capital gains, which are currently taxed at 0%, or charitable contributions, which are tax deductible. President Obama has proposed a surtax on millionaires, calling it the "Buffett Rule," in order to make their effective tax rate at least as high as middle-income families. Suppose Buffett had paid the same effective rate on his taxable income, as the average of his office co-workers (36%). Then his federal tax bill would have been $14.4 million, rather than the $6.9 million he actually paid. Yet as a fraction of his true income, the "Buffett Rule" would have made his effective tax rate rise from 6/100ths of 1% to 12/100ths of 1%.

In other words, Warren Buffett thinks he can do a better job with his money than give it to the government. I guess he's really not so different from the rest of us after all. That's the beauty of keeping all tax rates low, and not just those on unrealized capital gains (which are currently taxed at 0%).

Buffett's donation to the Gates Foundation goes to the very heart of my critique of his public call for higher tax rates on the rich. Here are his three conditions for his ongoing pledge to the Bill and Melinda Gates Foundation (I've switched the order for dramatic suspense):

1. Either Bill or Melinda Gates must be alive and actively involved in the management of the [Bill and Melinda Gates] foundation.

2. Starting in 2008, the total value of the previous year's gift must be spent.

3. The [Bill and Melinda Gates] foundation must continue to satisfy the legal requirements qualifying Warren's gift as charitable, exempt from gift or other taxes.

In other words, if his gift weren't tax sheltered he wouldn't give it. So much for "shared sacrifice."

Incidentally, we're not the first to question Warren Buffett's commitment to "shared sacrifice" in balancing the federal budget. In 2007 Rebecca (Becky) Quick of CNBC asked Buffett why he shelters his money through tax-free strategies, rather than writing big checks to Uncle Sam. Here was his answer:

> Well, that's a choice and it's an option … If I had to give it to a single individual, or make some young Buffett a multibillionaire, or give it to the government, I'd absolutely give it to the government. I think that on balance the Gates Foundation, my daughter's foundation, my two sons' foundations will do a better job with lower administrative costs and better selection of beneficiaries than the government.

In other words, Warren Buffett thinks he can do a better job with his money than give it to the government. I guess he's really not so different from the rest of us after all. That's the beauty of keeping all tax rates low, and not just those on unrealized capital gains (which are currently taxed at 0%).

BITING THE HAND THAT FEEDS YOU

Buffett also states in his *New York Times* op-ed that in his 60 years working with investors he has yet to see anyone "shy away from a sensible investment"…"even when capital gains rates were 39.9% in 1976-77." Buffett's choice of 1976-1977 is prescient because the economy in 1977 was a basket case. The official BLS unemployment rate was 7.1%, consumer price inflation was 6.7%, and the S&P 500 dropped 11.5% in nominal terms, or a whopping 17% after adjusting for inflation. 1977 is a good illustration of the type of economy Buffett's policies would deliver.

The true irony here is that just about everybody (except Warren Buffett) recognizes that capital gains are extremely sensitive to the supply-side effects of capital gains tax rates. His mega-rich friends focus on tax rates like laser beams. Realized capital gains tumble when tax rates on them rise and soar when tax rates fall. Just check the numbers.

Buffett continues writing about his investor friends stating that "people invest to make money, and potential taxes have never scared them off." And to make his point he compares the 1980 to 2000 period when 40 million jobs were created, to what's happened since 2000 with lower tax rates and fewer jobs created. Surprisingly Buffett is actually trying to cite the phenomenal growth during the period 1980-2000 as a result of high taxes. But of course, the 1980s and 1990s should be used as Exhibit A for why Buffett's proposals are dead wrong. During the period 1980 through 2000, the top marginal income tax rate was slashed from 70% to 39.6%, the capital gains tax rate was dropped to 20% from 39.9% in 1977 with capital gains on the sale of homes to virtually 0%.

Setting aside his sincerity, Buffett's proposals would stifle economic growth and paradoxically might even reduce tax receipts, depending on the numbers. Despite Buffett's claim to the contrary, of course investors and other high-income earners take tax consequences very seriously when structuring their activities.

And when it comes to raising tax revenues by raising tax rates on the rich Buffett would again appear to be on the wrong side of the argument.

Setting aside his sincerity, Buffett's proposals would stifle economic growth and paradoxically might even reduce tax receipts, depending on the numbers. Despite Buffett's claim to the contrary, of course investors and other high-income earners take tax consequences very seriously when structuring their activities. It might be true that a blue collar, 9-to-5 wage earner punching a clock is largely unresponsive to marginal income tax rates: he's going to go to work at his job, regardless.

Yet when it comes to the "mega-rich," things are different. The rich can afford armies of tax accountants and lawyers, and can alter the timing, location, and composition of their income. The rich can always shift their investments into tax-advantaged strategies. Since Warren Buffett is a master at playing the game, he knows exactly what we mean.

The empirical record illustrates the supply-side theory quite well. Because tax receipts would naturally grow with the economy with the passage of time, it's no feat to demonstrate that the absolute amount of taxes paid by the rich went up after a reduction in marginal tax rates. Therefore, to stack the deck against us, we'll look at taxes paid as a percentage of GDP. If Buffett were correct, and the rich didn't alter their behavior in light of tax incentives, then we'd expect taxes paid by the rich, as a share of the economy, to fall after an episode of "tax cuts for the rich." On the other hand, if the supply-siders are right, it's not clear what would happen. The rich would earn and report more income, but would pay lower tax rates. As a result tax revenues could go either way. In short, if the rich ended up paying a higher share of GDP in taxes—especially if it happened in several different historical episodes—then that would be pretty conclusive evidence in favor of the supply-side theory. So what does the record say?

From 1921 through 1928 the top marginal personal income tax rate fell from 73% to 25%. During this period, tax receipts from the top 1% of income earners rose from 0.6% of GDP to 1.1% of GDP. Under the Kennedy tax cuts from 1960 to 1968, the top income tax rate dropped from 91% to 70%, while tax receipts from the top 1% of earners rose from 1.3% of GDP to 1.9%

of GDP. By the way, these periods were two of the biggest booms in U.S. history. Guess which period was the third period of boom?

Since 1978, the top earned income tax rate fell from 50% to 35%, the top capital gains tax rate fell from 39.9% to 15%, and the highest dividend rate fell from 70% to 15%. President Clinton virtually eliminated the capital gains tax from the sale of owner-occupied homes and cut government spending as a share of GDP by the largest amount ever. The top 1% went from paying taxes of 1.5% of GDP in 1978, up to 3.3% of GDP in 2007. The bottom 95%, on the other hand, saw their tax payments drop from 5.4% of GDP in 1978 to 3.2% of GDP in 2007. Why would Buffett want to reverse these numbers?

Of course, cynics might object to the above evidence on the grounds that it was driven by an explosion of income gains. But that's largely the point.

The theory behind the Laffer Curve says that by reducing the penalties on the people most able to generate taxable income, the government will see a large rise in the tax base and, depending on the numbers, may end up collecting more total tax receipts. Now if in practice we see an increase in revenues, of course this will occur when the upper brackets have a surge in their incomes. We have to ask the cynics, what exactly is your goal? You have been saying you want to raise tax rates on the rich to close the budget deficit. Is that really the objective, or instead is it to simply punish people who are making an "unfair" amount of money?

CONCLUSION

Warren Buffett's public call for the government to raise taxes on him and other "mega-rich" citizens is both hypocritical and dangerous. It is hypocritical because Buffett quite consciously shields almost the entirety of his true income from federal income taxation, and makes no bones about his belief that he can do more good with his wealth than Uncle Sam. Buffett's call for higher tax rates is dangerous because doing so would stifle economic growth and, depending on the severity of the hikes, could actually reduce federal revenue relative to what it otherwise would have been. **LC**

ENDNOTES

1 Warren Buffett, "Stop Coddling the Super-Rich," *New York Times* (15 Aug. 2011) A21.
2 Arthur B. Laffer and Ford M. Scudder, "The Onslaught from the Left, Part II: Presidential Politics," Laffer Associates (25 Jan. 2008).
3 Buffett, "Stop Coddling the Super-Rich," *New York Times*.
4 Douglas Holtz-Eakin, "The Tax Code's Impact on the Reliability of Revenue Projections," CBO Testimony (22 July 2004).
5 See the compilation of the *Forbes* data.
6 All information regarding Buffett's gift to the Gates Foundation.
7 "Warren Buffett's Tax Dodge," *The Wall Street Journal* (17 Aug. 2011).
8 Buffett, "Stop Coddling the Super-Rich," *New York Times*.
9 Arthur B. Laffer and Stephen Moore, "The Onslaught from the Left, Part III: The Capital Gains Tax," Laffer Associates (5 Feb. 2008).
10 Buffett, "Stop Coddling the Super-Rich," *New York Times*.
11 Tax data from IRS statistics of income (SOI).

THE WALL STREET JOURNAL.

http://www.wsj.com/articles/SB10001424052748704113504575264513748386610

OPINION

Tax Hikes and the 2011 Economic Collapse

Today's corporate profits reflect an income shift into 2010. These profits will tumble next year, preceded most likely by the stock market.

By **ARTHUR LAFFER**
Updated June 6, 2010 12:01 a.m. ET

People can change the volume, the location and the composition of their income, and they can do so in response to changes in government policies.

It shouldn't surprise anyone that the nine states without an income tax are growing far faster and attracting more people than are the nine states with the highest income tax rates. People and businesses change the location of income based on incentives.

Likewise, who is gobsmacked when they are told that the two wealthiest Americans—Bill Gates and Warren Buffett—hold the bulk of their wealth in the nontaxed form of unrealized capital gains? The composition of wealth also responds to incentives. And it's also simple enough for most people to understand that if the government taxes people who work and pays people not to work, fewer people will work. Incentives matter.

People can also change the timing of when they earn and receive their income in response to government policies. According to a 2004 U.S. Treasury report, "high income taxpayers accelerated the receipt of wages and year-end bonuses from 1993 to 1992—over $15 billion—in order to avoid the effects of the anticipated increase in the top rate from 31% to 39.6%. At the end of 1993, taxpayers shifted wages and bonuses yet again to avoid the increase in Medicare taxes that went into effect beginning 1994."

Just remember what happened to auto sales when the cash for clunkers program ended.

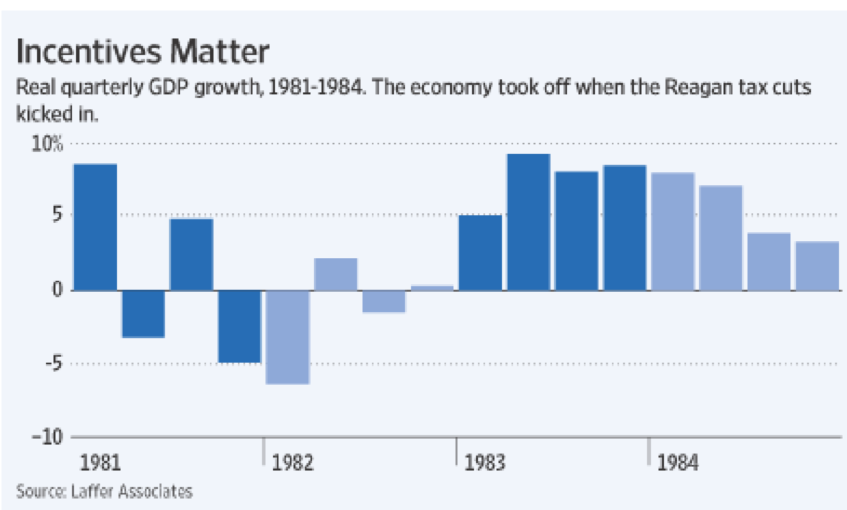
MORE

- Gay Couples Get Equal Tax Treatment (/articles/SB10001424052748704080104575286931017169308)
- IRS Nears Action on Church Pensions (/articles/SB10001424052748704080104575286960632243300)
- **Complete Coverage:** WSJ.com/Taxes (http://online.wsj.com/public/page/news-personal-finance-taxes.html)

Or how about new housing sales when the $8,000 tax credit ended? It isn't rocket surgery, as the Ivy League professor said.

On or about Jan. 1, 2011, federal, state and local tax rates are scheduled to rise quite sharply. President George W. Bush's tax cuts expire on that date, meaning that the highest federal personal income tax rate will go 39.6% from 35%, the highest federal dividend tax rate pops up to 39.6% from 15%, the capital gains tax rate to 20% from 15%, and the estate tax rate to 55% from zero. Lots and lots of other changes will also occur as a result of the sunset provision in the Bush tax cuts.

Tax rates have been and will be raised on income earned from off-shore investments. Payroll taxes are already scheduled to rise in 2013 and the Alternative Minimum Tax (AMT) will be digging deeper and deeper into middle-income taxpayers. And there's always the celebrated tax increase on Cadillac health care plans. State and local tax rates are also going up in 2011 as they did in 2010. Tax rate increases next year are everywhere.



Now, if people know tax rates will be higher next year than they are this year, what will those people do this year? They will shift production and income out of next year into this year to the extent possible. As a result, income this year has already been inflated above where it otherwise should be and next year, 2011, income will be lower than it otherwise should be.

Also, the prospect of rising prices, higher interest rates and more regulations next year will further entice demand and supply to be shifted from 2011 into 2010. In my view, this shift of income and demand is a major reason that the economy in 2010 has appeared as strong as it has. When we pass the tax boundary of Jan. 1, 2011, my best guess is that the train goes off the tracks and we get our worst nightmare of a severe "double dip" recession.

In 1981, Ronald Reagan—with bipartisan support—began the first phase in a series of tax cuts passed under the Economic Recovery Tax Act (ERTA), whereby the bulk of the tax cuts didn't take effect until Jan. 1, 1983. Reagan's delayed tax cuts were the mirror image of President Barack Obama's delayed tax rate increases. For 1981 and 1982 people deferred so much economic activity that real GDP was basically flat (i.e., no growth), and the unemployment rate rose to well over 10%.

But at the tax boundary of Jan. 1, 1983 the economy took off like a rocket, with average real growth reaching 7.5% in 1983 and 5.5% in 1984. It has always amazed me how tax cuts don't work until they take effect. Mr. Obama's experience with deferred tax rate increases will be the reverse. The economy will collapse in 2011.

Consider corporate profits as a share of GDP. Today, corporate profits as a share of GDP are way too high given the state of the U.S. economy. These high profits reflect the shift in income into 2010 from 2011. These profits will tumble in 2011, preceded most likely by the stock market.


ASSOCIATED PRESS

In 2010, without any prepayment penalties, people can cash in their Individual Retirement Accounts (IRAs), Keough deferred income accounts and 401(k) deferred income accounts. After paying their taxes, these deferred income accounts can be rolled into Roth IRAs that provide after-tax income to their owners into the future. Given what's going to happen to tax rates, this conversion seems like a no-brainer.

The result will be a crash in tax receipts once the surge is past. If you thought deficits and unemployment have been bad lately, you ain't seen nothing yet.

Mr. Laffer is the chairman of Laffer Associates and co-author of "Return to Prosperity: How America Can Regain Its Economic Superpower Status" (Threshold, 2010).

THE WALL STREET JOURNAL.

http://www.wsj.com/articles/SB10001424052748703882404575520241519315372

OPINION

The Bill Gates Income Tax

If Washington's most famous billionaires are really worried about their state's finances, they'd write personal checks to the government and leave everyone else alone.

By **ARTHUR LAFFER**

Updated Oct. 5, 2010 12:01 a.m. ET

Framed on a wall in my office is a personal letter to me from Bill Gates the elder. "I am a fan of progressive taxation," he wrote. "I would say our country has prospered from using such a system—even at 70% rates to say nothing of 90%."

It's one thing to believe in bad policy. It's quite another to push it on others. But Mr. Gates Sr.—an accomplished lawyer, now retired—and his illustrious son are now trying to have their way with the people of the state of Washington.

Mr. Gates Sr. has personally contributed $500,000 to promote a statewide proposition on Washington's November ballot that would impose a brand new 5% tax on individuals earning over $200,000 per year and couples earning over $400,000 per year. An additional 4% surcharge would be levied on individuals and couples earning more than $500,000 and $1 million, respectively.

Bill Gates Sr. *ASSOCIATED PRESS*

Along with creating a new income tax on high-income earners, Initiative 1098 would also reduce property, business and occupation taxes. But raising the income tax is the real issue. Doing so would put the state's economy at risk.

To imagine what such a large soak-the-rich income tax would do to Washington, we need only examine how states with the highest income-tax rates perform relative to their zero-income tax counterparts. Comparing the nine states with the highest tax rates on earned income to the nine states with no income tax shows how high tax rates weaken economic performance.

In the past decade, the nine states with the highest personal income tax rates have seen gross state product increase by 59.8%, personal income grow by 51%, and population increase by 6.1%. The nine states with no personal income tax have seen gross state product increase by 86.3%, personal income grow by 64.1%, and population increase by 15.5%.

It's striking how the high-tax states have underperformed relative to those with no income tax. Especially noteworthy is how well Washington has performed compared to states with no income tax.

If Washington passes Initiative 1098, it will go from being one of the fastest-growing states in the country to one of the slowest-growing. And passage of I-1098 will only be the beginning. Just look at Ohio, Michigan and California to see that once a state adopts an income tax, there is no end to the number of reasons that such a tax could be extended, expanded and increased.

Over the past 50 years, 11 states have introduced state income taxes exactly as Messrs. Gates and their allies are proposing—and the consequences have been devastating.

- The 11 states where income taxes were adopted over the past 50 years are: Connecticut (1991), New Jersey (1976), Ohio (1971), Rhode Island (1971), Pennsylvania (1971), Maine (1969), Illinois (1969), Nebraska (1967), Michigan (1967), Indiana (1963) and West Virginia (1961).

Each and every state that introduced an income tax saw its share of total U.S. output decline. Some of the states, like Michigan, Pennsylvania and Ohio, have become fiscal basket cases. As the nearby chart shows, even West Virginia, which was poor to begin with, got relatively poorer after adopting a state income tax.

Washington's I-1098 proposes a state income tax with a maximum rate higher than any of those initially adopted by the other 11 states. In one fell swoop, Washington would move from being one of the lowest-tax states in the nation to being one of the top nine highest. It's economic suicide.

The states that have high income tax rates or have adopted a state income tax over the past 50 years haven't even gotten the money they hoped for. They haven't avoided budget crises, nor have they provided better lives for the poor. The ongoing financial travails of California, New Jersey, Ohio, Michigan and New York are cases in point.

Over the past decade, the nine states with the highest tax rates have experienced tax revenue growth of 74%—a full 22% less than the states with no income tax. Washington state has done better than the average of the nine no-tax states. Why on earth would it want to introduce a state income tax when it means less money for state coffers?

What's true for those states with the highest tax rates is doubly true for the 11 states that have instituted state income taxes over the past half-century. They too have lost huge sums of tax revenue.

A final thought for those who want to punish the rich for their success: As the nearby chart shows, those states with the highest tax rates, and those states that have introduced state income taxes, have seen standards of living (personal income per capita) substantially underperform compared to their no-tax counterparts.

The High Cost of State Income Taxes

Relative economic performance of the 11 states that adopted income taxes in the past 50 years.

	Gross state product relative to the U.S.		Personal income per capita relative to the U.S.	
	Prior to income tax	2008	Prior to income tax	2009
Connecticut	1.74%	1.53%	151%	139%
New Jersey	3.66	3.35	128	126
Ohio	5.42	3.33	115	90
Rhode Island	0.44	0.33	117	104
Pennsylvania	5.72	3.91	113	101
Maine	0.39	0.35	94	92
Illinois	6.52	4.47	133	106
Nebraska	0.67	0.59	108	99
Michigan	5.08	2.70	130	87
Indiana	2.61	1.80	114	86
West Virginia	NA	0.44	86	81

Source: Laffer Associates

If Mr. Gates Sr. and his son feel so strongly about taxing the rich, they should simply give the state a chunk of their own money and be done with it. Leave the rest of Washington's taxpayers alone.

Mr. Laffer is the chairman of Laffer Associates and co-author of "Return to Prosperity: How America Can Regain Its Economic Superpower Status" (Threshold, 2010).

American Enterprise Institute

Steve Conover

November 2, 2012 | The American

Understanding Romney's Approach to Taxes: 'Lower the Rates, Broaden the Base'

Politics and Public Opinion, Public Economics

Here's a clarification of the concepts behind the Romney-Ryan proposal for tax reform.

Republican presidential candidate Mitt Romney has made tax reform a centerpiece of his campaign. His catchphrase description of the proposal is "lower the rates and broaden the base," a concept that enjoys support not just from other Republican candidates, but also from Federal Reserve Chairman Ben Bernanke and the Bowles-Simpson Fiscal Commission.

But that catchphrase immediately introduces a problem: for the most part, only wonks know what "broaden the base" means. What follows is a two-step clarification of the concept.

For the income tax, "broadening the base" means increasing the amount of income subject to taxation — and there are two ways to do it. One way is to increase the "taxable income" line on the individual tax return. The second way is to increase the number of taxpayers in the economy, by accelerating the private sector's job creation.

1. Eliminating Deductions to "Broaden the Base" — Static Scoring

The first method of base-broadening, illustrated in Figure 1, focuses on a hypothetical individual tax return and shows what happens when the rate is lowered and the base is broadened by eliminating deductions. Note that, even if the whole pie (gross income) remains unchanged, the taxable income portion (inner circle) will grow as deductions are eliminated.

The red slices indicate tax dollars paid. When the tax rate decreases as taxable income increases, the slices can remain nearly the same size — i.e., there can be no tax increase or decrease on the individual return.

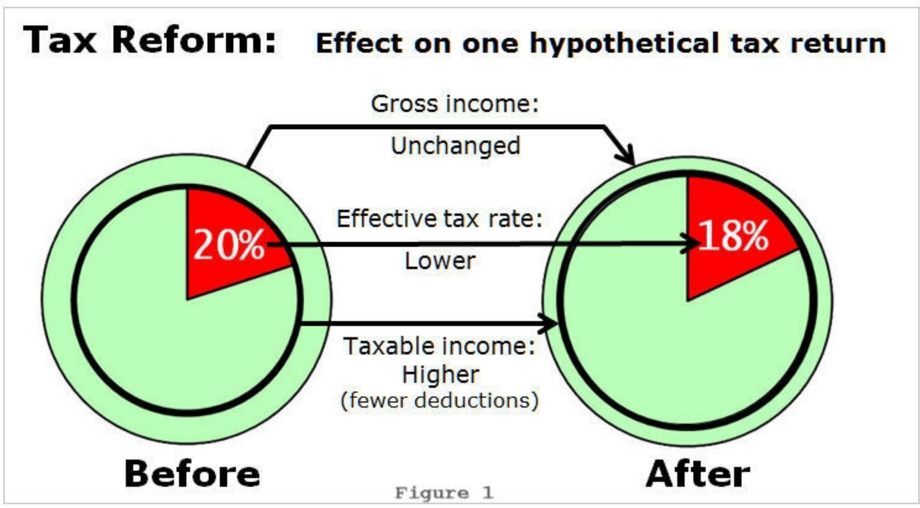


Figure 1

This is called a "microeconomic" analysis because it looks at the effect on individuals. And because it does not take into account the larger, macroeconomic effects — such as any resulting growth of the overall economy — it is also known as "static scoring," which is the government's official method for analyzing tax policy.

2. Accelerating Job Creation to "Broaden the Base" — Dynamic Scoring

Figure 2 illustrates the second method of base-broadening — putting more people to work, which would increase the number of tax returns being filed and grow the economy. When a new policy successfully enhances growth, the government enjoys larger tax revenue (the sum total of all the red slices), mainly because the number of taxpayers is increasing more rapidly. This is called a macroeconomic analysis because of its focus on a policy's effects on the whole economy.

Does the Romney tax proposal enhance the economy's growth rate? It is an important question, especially when the primary purpose of the proposal is to do just that: enhance the rate of job creation. Unfortunately, we cannot expect an official answer on this, because when the Congressional Budget Office (CBO) analyzes a tax policy proposal, it does not use "dynamic scoring," or measure any effect on growth. The Center on Budget and Policy Priorities (CBPP) tells us that CBO analyses "do not include an estimate of how and Policy Priorities (CBPP) tells us that CBO analyses "do not include an estimate of how any change in GDP would affect revenues." Why not? CBPP gives two reasons: (1) it's too hard to do; and (2) it would be controversial, and therefore open to politicization.

Eliminating the Goal of Reform from Tax Policy Analysis

Paradoxically, static analysis strikes private sector job growth, the *primary goal* of tax reform, from the *analysis* of tax reform. The resultant "scoring" is arguably reduced to an oversimplified microeconomic exercise that determines whether the *reduction* in federal tax revenue (by reducing the tax rates) would be offset by the *increase* in tax revenue (by eliminating deductions), within a workforce that somehow remains unaffected by changes in incentives induced by a new tax code.

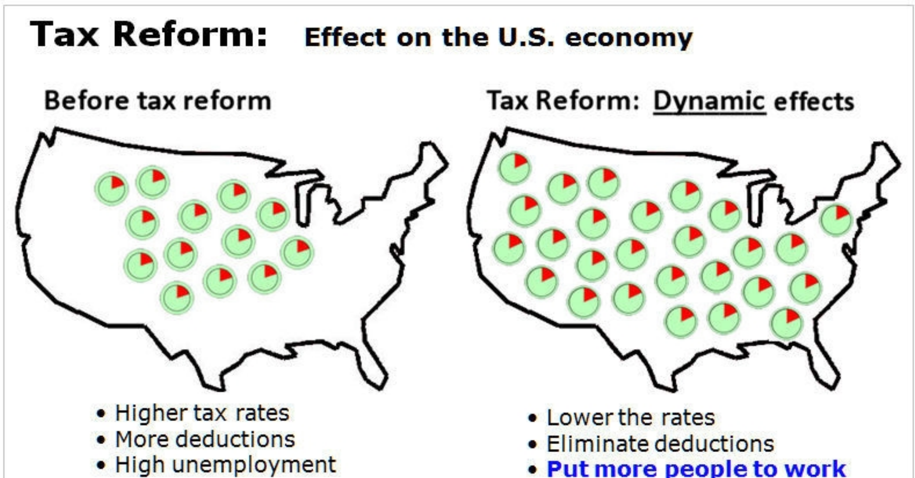


Figure 2

Static scoring ignores growth effects, which, if incorporated into an official analysis, would help to clarify the debate. Would tax reform (a) enhance economic growth; (b) hurt economic growth; or (c) have no effect on growth? We do not really know, because the answer would require dynamic scoring — which, as a recent Bloomberg article explains, "has been the subject of a decades-long debate between the parties." While the scorekeepers "don't assume that a [tax policy] change will increase the size of the economy," economists agree that "eventually a more efficient tax code with fewer distortions would be good for growth."

In other words, although everyone knows that growth is good, we choose to ignore it in our official scoring of tax policy proposals, even when the proposal's *overriding purpose* is to generate faster growth.

Romney's plan lays out the general principle: "U.S. GDP growth has averaged 3.3 percent over the past 50 years… But these are shadows that might be, not that must be. U.S. economic growth can be faster. All-important productivity growth can be lifted by better tax and regulatory policy. Changes in retirement ages, immigration policy, and support for employment can boost labor force growth." Dynamic scoring of growth and job-creation effects (bounded by a sufficiently wide confidence interval to allow for uncertainty) would give voters a better idea of what to expect from proposed policy changes.

Taking growth into account (dynamic scoring) is hard, and it is vulnerable to political games — but it's the only game in town for clarifying which side's job-creation ideas would be better for growing the macroeconomy and improving the nation's fiscal balance.

Glenn Hubbard, Dean of Columbia Business School, served in the Bush White House from February 2001 until March 2003 as the Chairman of the Council of Economic Advisers and the OECD's Economic Policy Committee {*Read more*}

Contact

For further information and media inquiries, please contact:

Rimjhim Dey
PUBLISEZ PR | **www.Publisez.com**
Send an email | *917.514.3359*

FINANCIAL TIMES – The Problem with Obama's Arithmetic

Wednesday, 05 September 2012 01:37

SOURCE:
FINANCIAL TIMES

The release last month of the Congressional Budget Office's update to the budget and economic outlook for the next decade rightly draws attention to the "fiscal cliff" – the large tax increases and spending cuts that are currently scheduled for January 1. But there's more to the CBO report than its analysis of what may happen in the next few months.

The CBO analysed the consequences for deficits and debt over the next decade of keeping tax and spending policy on autopilot. Relative to the agency's baseline, deficits would increase by almost $8tn over the next decade. And debt held by the public would reach about 90 percent of gross domestic product; its highest level since the second world war.

Elevated federal spending is the source of the widening deficits over the next decade. The CBO estimates that revenues as a share of GDP would average about 18 per cent, roughly their 40-year average. Federal spending at 23 per cent of GDP would at stand about 10 per cent higher than its 40-year average, 21 per cent.

Higher debt levels crowd out private investment. And they reduce household and business spending on account of higher expected future taxes to close the budget gap. The debt problem that the CBO identifies will get worse after the next decade with large and growing shortfalls in Social Security and Medicare. It is not an understatement to observe that the challenge of avoiding a high-debt, low-growth economy is the key domestic policy issue.

So what are the approaches of Governor Mitt Romney (who I advise) and President Barack Obama (who speaks tonight at the Democratic convention) to this central challenge?

Mr Romney's budget (for which I wrote the foreword) focuses on reducing debt burdens and enhancing economic growth through spending restraint and tax reform. Mr Romney proposes to reduce federal spending as a share of GDP to 20 percent by 2016 and gradually reduce the growth in Social Security and Medicare spending, particularly for more affluent households. The GOP candidate would reform the corporate and individual income taxes, reducing marginal tax rates by just under one-third for the corporate tax and by 20 per cent for the individual income tax, while broadening the tax base to make up lost revenue. The Romney plan addresses the deficit and debt challenge comprehensively, though both spending restraint and tax reform pose political challenges.

Mr Obama has proposed to continue current elevated levels of federal spending, while raising taxes on higher-income households and businesses to reduce the deficit and debt consequences of higher spending.

Indeed, Larry Summers, the president's former chief economic adviser, recently argued in the Financial Times that reducing federal spending as a share of GDP is not achievable. Mr Summers pointed to demographic change (population aging), higher interest payments on the large public debt (which has increased substantially in the past few years) and increases in the relative price of health (a significant component of government spending). This view is consistent with Mr Obama's budget, which assumes elevated levels of spending over his presidency and thereafter.

In contrast with Mr Romney's plan, the president's plan does not address medium-term and long-term deficit and debt problems. Taken at face value, the Obama plan will require acceptance of the costs of much higher levels of deficits and debt or substantial tax increases on all Americans. The CBO's report shows the consequences for deficits and debt over the next decade of such continued budget inaction.

But the president is proposing higher tax burdens on certain households and businesses. Will those tax changes close the budget gap? No.

The president says he will raise marginal tax rates on upper-income workers and business owners (against the grain of tax reform efforts over decades, including his own Fiscal Commission, which argued for lower marginal tax rates financed by broadening the tax base). His proposed revenue increases include the "Buffett rule" (effectively a new alternative minimum tax on high-income taxpayers), tax increases on dividends and capital gains, plus raising the top income tax rate to its pre-2001 level.

What are those tax increases? The Buffett rule imposes a minimum effective tax rate on taxpayers with annual incomes over $1m (most of whom already face a higher tax rate). For higher taxes on saving and investment, the president would raise taxes on capital gains to 20 per cent from 15 per cent and on dividends to 39.6 per cent from 15 per cent. Next, the president calls for restoring the pre-2001 tax rates for high-income individuals, including increasing the top marginal income tax rate to 39.6 per cent from 35 per cent. In addition, the president's budget also calls for phasing out exemptions and lower-bracket tax rates for higher-income taxpayers, raising marginal tax rates further. And the president would limit certain tax deductions for individuals with incomes over $200,000.

Adding up the proposed tax increases on upper-income taxpayers should raise $148bn per year in additional revenue, according to US Treasury department estimates. Viewed next to proposed additional spending by the president of roughly $500bn per year, Mr Summers's claim that federal spending will remain high, or this year's federal budget of $1.1tn, the president faces an arithmetic challenge.

Assuming the Obama administration wanted to close the budget gap – to be comparable with the lower deficits in the Romney plan – what additional tax increases would be required? To begin, let's call the maximum additional revenue from upper-income taxpayers $148bn per year, as the administration has not identified more tax increases on those taxpayers.

To close the budget gap, one could raise additional revenue by broadening the tax base. But the president's proposals already accomplish much of that for upper-income taxpayers. Additional tax base broadening would be required for middle-income taxpayers. Of course, the administration could propose an increase in marginal tax rates. Unless, though, the administration wants to raise marginal tax rates further on high-income individuals, marginal tax rates would have to be raised – and substantially – on middle-income taxpayers. Of course, the deficit and debt could simply be allowed to rise, not a sustainable long-term solution for the country.

The choices of the size of government and how we pay for it are fundamental ones. They are also the ones we should be analysing and debating. Mr Romney has proposed a plan of fiscal consolidation and tax reform. Accomplishing it will require reducing the growth of federal spending and broadening the tax base. These changes will not be easy. Mr Obama proposes a larger government with explicitly higher taxes on high-income taxpayers but, by the arithmetic of higher spending levels, eventually higher taxes on all Americans.

This op-ed by Glenn Hubbard appeared in The Financial Times, September 5, 2012.

The Seven Lies of Robert Reich

By
Jan 30, 2012

Robert Reich who was secretary of labour under Bill Clinton wrote an article that he called “The Seven Biggest Economic Lies”. I intend to show the reader how deeply flawed this article is in the hopes that sound economic principles may get the attention that they deserve. I will not take his statements out of context but rather quote them in their entirety.

Robert Reich's writes: 1. *Tax cuts for the rich trickle down to everyone else.* Baloney. Ronald Reagan and George W. Bush both sliced taxes on the rich and what happened? Most Americans' wages (measured by the real median wage) began flattening under Reagan and have dropped since George W. Bush. Trickle-down economics is a cruel joke.

If you cut taxes and keep spending like a drunken sailor like G.W. Bush and Reagan did, you need to make up the difference by either printing money or borrowing, which are forms of taxation as well. So in fact, using those two presidents as examples of why low taxes don't work is inaccurate. Money printing and borrowing are less visible than outright taxation so politicians can claim that they cut taxes while taxing us through the back door.

On the other hand if you really cut or eliminate taxes, and at the same time reduce or eliminate government spending, there will be more accumulation of capital which leads to higher real wages.

About 100 years ago, about 98% of the population worked the land in food production. Today, farmers in advanced economies have all kinds of machinery and technology which has made them more productive. This has a twofold effect of improving the earnings of farmers and lowering food costs for the entire population. People will object by saying that farmers today do not earn much, but if you compare the standard of living of a farmer today with that of a farmer 100 years ago, you will understand what I mean.

This whole process of wealth creation is made possible through the accumulation of capital which is what farmers in poor countries do not have. Today only 2% of our population is engaged in farming thereby allowing the rest of the population to produce goods and services that were not available or were too costly for widespread consumption back when we were all farmers. This higher productivity leads to a better standard of living for everyone and government taxation impairs this process.

Robert Reich's writes: 2. *Higher taxes on the rich would hurt the economy and slow job growth.* False. From the end of World War II until 1981, the richest Americans faced a top marginal tax rate of 70 percent or above. Under Dwight Eisenhower it was 91 percent. Even after all deductions and credits, the top taxes on the very rich were far higher than they've been since. Yet the economy grew faster during those years than it has since. (Don't believe small businesses would be hurt by a higher marginal tax; fewer than 2 percent of small business owners are in the highest tax bracket.)

Ask yourself: Would you put your capital at risk and work hard only to retain as little as 9% of what you produced? When people are faced with such punitive tax rates they take their capital elsewhere, avoid taxes, or stop working altogether.

Reich believes that the rich stood idle while the government took 70 to 91% of their income, which is very naive. Not only were there endless loopholes in the tax code, but each time taxes are raised the rich put their money into tax free investments. Let us not forget also that those were the golden days of bank secrecy and offshore money heavens, and taking money out of the country was very easy.

> **Robert Reich's writes: 3. *Shrinking government generates more jobs.*** Wrong again. It means fewer government workers – everyone from teachers, fire fighters, police officers, and social workers at the state and local levels to safety inspectors and military personnel at the federal. And fewer government contractors, who would employ fewer private-sector workers. According to Moody's economist Mark Zandi (a campaign advisor to John McCain), the $61 billion in spending cuts proposed by the House GOP will cost the economy 700,000 jobs this year and next.

If this were true then why not employ everyone in the government.

Mr. Reich talks as if the government paid for all those jobs with resources dropped from heaven. The truth is that every dollar spent by government is a dollar that has to be taken from somewhere. If I spend my money on a suit, or if I invest it, I also generate jobs, and they will be productive jobs. I don't need the government to spend the money for me.

Governmental employees and contractors piggyback their jobs on the rest of us.

> **Robert Reich's writes: 4. *Cutting the budget deficit now is more important than boosting the economy.*** Untrue. With so many Americans out of work, budget cuts now will shrink the economy. They'll increase unemployment and reduce tax revenues. That will worsen the ratio of the debt to the total economy. The first priority must be getting jobs and growth back by boosting the economy. Only then, when jobs and growth are returning vigorously, should we turn to cutting the deficit.

There are so many economic fallacies concentrated in that short paragraph! I will simplify my answer by asking you to ask yourself some simple questions: When you have personal economic troubles, do you spend more? Do you borrow to spend more?

Remember, economics works in exactly the same way for one individual, a family, a company or a country. What is true for one individual is true for a country. To claim the opposite is like to claim that there is no gravity in government offices.

> **Robert Reich's writes: 5. *Medicare and Medicaid are the major drivers of budget deficits.*** Wrong. Medicare and Medicaid spending is rising quickly, to be sure. But that's because the nation's health-care costs are rising so fast. One of the best ways of slowing these costs is to use Medicare and Medicaid's bargaining power over drug companies and hospitals to reduce costs, and to move from a fee-for-service system to a fee-for-healthy outcomes system. And since Medicare has far lower administrative costs than private health insurers, we should make Medicare available to everyone.

Mr. Reich talks about "bargaining power" but why doesn't this great bargaining power work with the military industrial complex? Or with the post office which the government could never run profitably in spite of having a monopoly?

The reality is that government never does anything efficiently and always uses its leverage to benefit special interest groups which is why healthcare is so expensive. Why do you think insurance companies supported Obamacare?

When the government restricts the number of medical schools we can have, the number of doctors we can have, or if it restricts supply of services with licensing hurdles, it benefits corporations and professional groups at the expense of the rest of the population, at your expense.

If we want lower costs and better service, we need more competition, not less.

> **Robert Reich's writes: 6. *Social Security is a Ponzi scheme.*** Don't believe it. Social Security is solvent for the next 26 years. It could be solvent for the next century if we raised the ceiling on income subject to the Social Security payroll tax. That ceiling is now $106,800.

Well, actually, Social Security fits the definition of a Ponzi scheme to the letter, which is "an investment operation that pays returns to its investors from their own money or the money paid by subsequent investors, rather than from any actual profit earned by the individual or organization running the operation".

Mr Reich claims that Social Security "is still solvent" for another 26 years, but this is a feature of all Ponzi schemes: they are solvent for a while until their new incoming money is less than the payouts. Bernie Madoff was "solvent" until he no longer was able to pay. Raising the ceiling on income merely postpones the inevitable end of all Ponzi schemes.

> **Robert Reich's writes:** **7. *It's unfair that lower-income Americans don't pay income tax.*** Wrong. There's nothing unfair about it. Lower-income Americans pay out a larger share of their paychecks in payroll taxes, sales taxes, user fees, and tolls than everyone else.

For once I agree with Reich. It is not unfair that the lower-income classes don't have part of their income taken from them by force, this is a great thing.

What is unfair is that the rest of the population is subject to this theft. Remember that slaves did receive part of what they produced in the form of food and shelter. The difference between taking 90% of someone's income as in the case of slavery, and taking 30% in taxation is only a difference in degree.

Most of the failures in Mr Reich's reasoning have to do with not looking at the unseen consequences of the policies he advocates. The reader may be interested in Bastiat's famous essay "That which is seen and that which is not seen" which is a wonderful explanation of this common fallacy.