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The High Costs of Soak-the-Rich Taxation

During his Presidential campaign, Bill Clinton insisted that wealthier people should pay more individual income taxes. According to Mr. Clinton and his advisers, taking more money from upper-income individuals would be fair, easy, and cause little, if any, harm to the economy. In fact, they are wrong on all counts. Steeper taxes on upper-income individuals would not be fair. Most of the added revenues that the incoming administration thinks is there for the taking would never materialize. The heavier taxes would damage the economy and would hurt everyone. The maneuver would also increase the middle class's political exposure to higher taxes.

The call for higher tax rates on upper-income individuals follows a path that Congressional Democrats embarked on before the ink was even dry on the Tax Reform Act of 1986. They have been trying to raise tax rates while retaining the drastically expanded definition of taxable income contained in the 1986 act. In early 1992, for instance, Congressional Democrats passed a tax bill (which President Bush vetoed) that would have added a fourth tax bracket of 36%, tacked on a 10% millionaires' surtax, extended the phase-out of itemized deductions and personal exemptions for upper-income individuals, and barred companies from deducting compensation to any executive in excess of $1 million.

The notion that higher-income people are not paying their "fair share" of income taxes ignores the disproportionate share of taxes they already pay. In 1990, the top 1% of tax filers paid about one-quarter of all individual income taxes, the top 2% paid about one-third, and the top one-half of filers paid over 90%. Far from getting off lightly, upper-income individuals pay the lion's share of individual income taxes. Indeed, it is plausible to argue from the numbers that if anyone is being taken advantage of by the tax system, it is upper-income individuals. They contribute much more in taxes than do other people and their taxes take a disproportionately larger share of the fruits of their labor and saving.

Denying people, solely on the basis of their income, legitimate personal exemptions and itemized deductions that are available to everyone else is blatantly discriminatory. Although extending these disallowances is an integral part of many "fairness" packages, such selective disallowances are the epitome of unfairness.

The proposal to limit the deductibility of executive compensation would violate a core principle of sound income taxation: expenses, including payroll costs, should be deducted in computing taxable income. This attempt at government micromanagement of compensation would also send the perverse message that Washington thinks business executives, whose decisions play such a large role in determining America's job outlook and competitiveness, are somehow less important than top athletes, actors, and rock stars, whose salaries would not be subject to the cap. Ironically, to the extent that the cap would raise major corporations' tax bills, the middle class would foot much of the tab because they have large corporate holdings through pensions, mutual funds, and direct stock ownership.

Those who contend that higher-income individuals deserve to be taxed more heavily should be required to explain how they define fairness before their demands are written into law. In the absence of an objective definition, "fairness" is an out-of-control concept with no logical stopping point; it is used to rationalize any degree of income redistribution, no matter how extreme. There is no solid, objective basis for

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concluding that it would be more equitable if tax rates were more progressive.

During the campaign, Mr. Clinton said that an appreciable chunk of the added tax revenues he wanted could be gotten from the wealthy. That is largely wishful thinking. People respond vigorously to tax incentives, and upper-income individuals are particularly sensitive because they already send so much of their income to Washington. If the tax climate changes adversely, they will quickly modify their behavior to reduce their exposure. They have enough at stake that it is worth their while to consult closely with accountants and financial advisers in developing tax-minimization strategies. For example, many business executives (most prominently Michael Eisner of Disney) have exercised stock options this year or taken early bonuses in order to beat the tax hikes anticipated for next year. Three of the most obvious options for upper-income individuals are to work less, to save and invest less, and to take more of their compensation in nonmonetary fringe benefits. Therefore, it is not clear that much more tax revenue would be extracted from upper-income taxpayers.

In the 1980s, when statutory tax rates decreased dramatically, the share of income taxes paid by people at the top of the income distribution actually rose. That may have been because many tax-minimization strategies were no longer worth the bother and, accordingly, more income was taken in taxable forms. If the government more steeply graduates tax rates, that trend may well reverse itself.

Higher taxes are also likely to have disappointing revenue results because they will weaken the economy. When an economy is strong and growing, it throws off an enormous quantity of added tax dollars; when an economy falters, that revenue source disappears.

This introduces the biggest problem caused by soak-the-rich taxation. Income is generated by people's activities that have value in the marketplace. People with higher-than-average incomes tend to be in that position because they are more productive and have had the foresight to save and invest wisely. By targeting these individuals' top dollars of income for especially heavy taxation, many of the proposed tax changes would have the effect of singling out especially productive economic activities for the highest rates of taxation.

Since the natural response to steeper taxes is to supply fewer of the taxed services, upper-income people would reduce their work efforts, and output would drop immediately. The cutbacks in saving and investment could be even more damaging. Upper-income individuals have the greatest capacity to save and, based on their track records, are some of the best judges of investment opportunities. Because investment is one of the main forces increasing productivity, the falloff in investment would cause the U.S. economy to grow more slowly and be less competitive in world markets. That would hurt everyone. For example, although poor people would not pay the more steeply progressive taxes directly, they would suffer from higher unemployment (they tend to be the last ones hired and first laid off), lower real wages (wages are linked to productivity), and diminished prospects for improved future living standards.

Even if one looks only at direct tax effects, attempts to confine tax increases to the wealthy tend to backfire. Many people probably believe that if tax rates go up for the "rich", it is less likely that their own taxes will increase. In reality, the contrary is probably true. Higher tax rates on the "rich" increase the odds that middle-class households will be hit with heavier taxes.

One reason is that since the majority of potential tax dollars belong to the middle class, "that's where the money is," so politicians are tempted to define "rich" creatively. Based on past performances, it is virtually certain that their expansive categorization of the wealthy will capture a large number of single professionals, small business owners, and two-income households, most of whom work hard, put in long hours, and definitely do not consider themselves to be on easy street. The 1986 Tax Act, for instance, began its highest rate bracket at a taxable income of $43,150 for single filers and $71,900 for couples.

Another reason the middle class should expect heavier taxes when the government promises to soak the rich is that tax rates on the "rich" set an upper bound on everyone else's taxes. As soon as the ceiling goes up, it becomes politically much easier to

increase various taxes that are primarily paid by the middle class (excises like the gas tax, for example). Elected officials point to the top rate brackets and use the excuse that the middle class is still taxed less severely than the wealthy.

Higher taxes that are supposedly directed at upper-income individuals have the added disadvantage that they would further complicate the tax code. Several of the proposals being circulated involve special restrictions, phase-outs, and schedules. Many taxpayers would encounter large compliance burdens in trying to understand the special rules, assembling and maintaining the necessary records, and performing the extra tax computations that would be required. For illustration, the IRA deduction was extremely simple until Congress, in 1986, decided to limit its use by the "better off" — single filers with taxable incomes of $25,000 or more and married couples with taxable incomes of $35,000 or more. Now, millions of people who wish to make IRA contributions are confronted with tedious calculations and life-long record-keeping requirements.

As nominal taxes rise and the inefficiencies and injustices they create become more acute, demands would increase for selective relief. With that, the tax code would be headed back to the old system in which high nominal rates were coupled with numerous technical rules granting specialized relief to both deserving taxpayers and politically influential ones.

Higher taxes on the "rich" have the seductive appeal for most people that they seem to shift more of the tax load onto others. In actuality, the shift is mostly an illusion. The weaker economy that results from selectively discouraging some of the most productive activities harms individuals at all income levels. The more steeply increasing schedule of effective tax rates opens the door politically to higher taxes on the middle class. It also inserts more complexity into the tax code and encourages the proliferation of "loopholes" to provide selective relief. Although more progressive rates are often called fair, they move in the opposite direction in many ways. Nor are higher rates on the "rich" apt to live up to their advance billing as an easily tapped revenue source. If the Clinton Administration truly wants to put people first, it should reject the crude allure of class-envy taxation.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.