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ECONOMIC VIEW

Fair Taxes? Depends What You Mean by 'Fair'

By N. GREGORY MANKIW

DO the rich pay their fair share in taxes? This is likely to become a defining question during the presidential campaign.

At a recent fund-raiser for Hillary Clinton, the billionaire investor Warren E. Buffett said that rich guys like him weren't paying enough. Mr. Buffett asserted that his taxes last year equaled only 17.7 percent of his taxable income, compared with about 30 percent for his receptionist.

Mr. Buffett was echoing a refrain that is popular in some circles. Last year, Robert B. Reich, labor secretary during the Clinton administration, wrote on his blog that "middle-income workers are now paying a larger share of their incomes than people at or near the top."

"We have turned the principle of a graduated, progressive tax on its head," Mr. Reich added.

These claims are enough to get populist juices flowing. The problem with them is that they don't hold up under close examination.

The best source for objective data on the distribution of the tax burden is the Congressional Budget Office. The C.B.O. goes beyond anecdotes and bald assertions to provide hard data on who pays taxes. One can argue about the details of its methods, but there is no doubt that it is nonpartisan and that its tax analysts are some of the best in the business.

The C.B.O.'s most recent calculations of federal tax rates show a highly progressive system. (The numbers are based on 2004 data, but the tax code has not changed much since then.) The poorest fifth of the population, with average annual income of \$15,400, pays only 4.5 percent of its income in federal taxes. The middle fifth, with income of

\$56,200, pays 13.9 percent. And the top fifth, with income of \$207,200, pays 25.1 percent.

At the very top of the income distribution, the C.B.O. reports even higher tax rates. The richest 1 percent has average income of \$1,259,700 and forks over 31.1 percent of its income to the federal government.

One might wonder how Mr. Buffett gets away with a tax rate of only 17.7 percent, while a typical millionaire is paying so much more. Most likely, part of the answer is that Mr. Buffett's income is made up largely of dividends and capital gains, which are taxed at only 15 percent. By contrast, many other top earners pay the maximum ordinary income tax rate of 35 percent on their salaries, bonuses and business income.

The distinction is crucial for understanding how much the rich pay. Indeed, the share of top incomes coming from capital is much lower now than it has been historically. According to Emmanuel Saez, an economist at the University of California, Berkeley, for the richest Americans — those in the top 0.01 percent of the distribution — the percentage of income derived from capital fell to 25 percent in 2004 from 70 percent in 1929.

If your image of the typical rich person is someone who collects interest and dividend checks and spends long afternoons relaxing on his yacht, you are decades out of date. The leisure class has been replaced by the working rich.

Another piece of the puzzle is that Mr. Buffett's tax burden is larger than it first appears, because he is a major shareholder in Berkshire Hathaway.

When the C.B.O. studies the tax burden, it includes all federal taxes, including individual income taxes, payroll taxes and corporate income taxes. In its analysis, payroll taxes are borne by workers, and corporate taxes by the owners of capital. For the richest 1 percent of the population, 9.3 percentage points of their 31.1 percent tax rate comes from the taxes that corporations have paid on their behalf. The

corporate tax would undoubtedly loom large if the C.B.O. were to calculate Mr. Buffett's effective tax rate.

None of these calculations, however, say whether the rich are paying their fair share. Fairness is not an economic concept. If you want to talk fairness, you have to leave the department of economics and head over to philosophy.

The quintessential political philosopher of modern liberalism is John Rawls, the author of the 1971 classic "A Theory of Justice." Professor Rawls concluded that the primary goal of public policy should be to redistribute resources to help those at the very bottom of the economic ladder. If Professor Rawls were alive today, he would most likely want to raise the top income tax rate of 35 percent in order to finance a more generous safety net. And for much the same reason, he would probably raise taxes on the middle class as well.

Professor Rawls would get a vigorous debate from his Harvard colleague, the libertarian philosopher Robert Nozick. In his 1974 book, "Anarchy, State, and Utopia," Professor Nozick wrote: "We are not in the position of children who have been given portions of pie by someone who now makes last-minute adjustments to rectify careless cutting. There is no central distribution, no person or group entitled to control all the resources, jointly deciding how they are to be doled out. What each person gets, he gets from others who give to him in exchange for something, or as a gift. In a free society, diverse persons control different resources, and new holdings arise out of the voluntary exchanges and actions of persons."

To libertarians like Professor Nozick, requiring the rich to pay more just because they are rich is little more than officially sanctioned theft.

There is no easy way to bridge this philosophical divide, but the political process will, inevitably, try to forge a practical compromise among those with wildly divergent views. At the 2000 Republican National Convention, the candidate George W. Bush made clear where he stood: "On principle, no one in America should have to pay more than a third

of their income to the federal government.” As judged by the C.B.O. data, he has accomplished his goal.

A question for any political candidate today is whether he or she agrees with the Bush tax ceiling. If not, how high above a third is he or she willing to go?

Federal Taxes As a Share of Income

2004		
INCOME GROUP	AVERAGE PRETAX INCOME	EFFECTIVE FEDERAL TAX RATE
Lowest 20 percent	\$15,400	4.5%
Second 20 percent	36,300	10.0
Middle 20 percent	56,200	13.9
Fourth 20 percent	81,700	17.2
Highest 20 percent	207,200	25.1
Top 1 percent	1,259,700	31.1

Source: Congressional Budget Office

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