The Heritage Foundation Backgrounder

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The Thomas A. Roe Institute for Economic Policy Studies

July 18, 1997

CLASS-WARFARE TAX POLICY: MYTH AND REALITY

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The major argument against the pro-growth tax policies being debated in Congress seems to be that the "rich" will benefit from them disproportionately. Whether a proposal involves limited change like capital gains tax relief or fundamental reform like the flat tax, opponents are quick to charge that the result would be to make the tax code less fair.

A key element of this debate is the question of what constitutes fairness. Supporters of tax reform believe that fairness means treating all taxpayers equally before the law; a wealthy person who makes 100 times more than another person, for example, should pay 100 times more in taxes. Others believe in equality of results rather than equality of opportunity. As such, they want government to impose increasingly punitive tax rates on higher-income taxpayers to facilitate income redistribution.

Yet battles over tax policy, including the one now taking place in Washington, D.C., involve more than the subjective meaning of fairness. Claims about incomes, tax burdens, and historical trends abound. In all too many cases, however, the assertions being made are contradicted by the readily available numbers. For example:

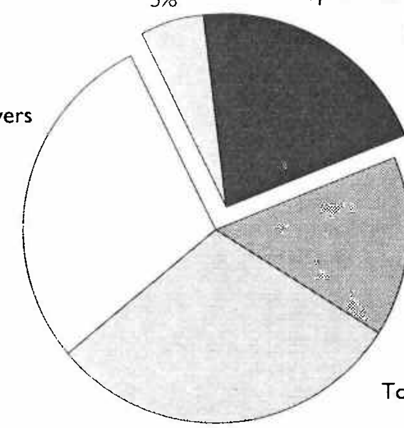
Myth: The rich don't pay their fair share.

Reality: According to IRS data,[1] the top 1 percent of income earners pay nearly 29 percent of the income tax burden, the top 10 percent pay more than 59 percent, and the top 20 percent pay more than 74 percent. The bottom 50 percent of income earners, on the other hand, pay less than 5 percent of income taxes.

1 Tax Foundation news release, "Top Income Earners Continue to Shoulder Greater Share of Income Taxes," September 24, 1996.

Chart 1

Rich Not Paying their Share? Top 20% of Taxpayers Pay Nearly Three-Quarters of the Income Tax Burden



1997 Estimated Income Taxes Paid

Source: Tax Foundation.

Myth: Lower tax rates mean the rich will pay less.

Reality: This outcome depends on how much tax rates are reduced. History indicates that the revenue-maximizing rate is less than 30 percent.[2] In other words, when marginal rates are higher than 30 percent, the rich probably will pay more if rates are lowered. The reason? Because incentives to hide, shelter, and underreport income are reduced.

Consider what happened the three times this nation enjoyed significant tax rate reductions:

- **1920s:** The top tax rate fell from 73 percent to 25 percent, yet the rich (in those days, those earning $50,000 and up) went from paying 44.2 percent of the tax burden in 1921 to paying more than 78 percent in 1928.[3]
- **1960s:** President John F. Kennedy slashed the top tax rate from 91 percent to 70 percent. In the ensuing three years, those making more than $50,000 annually saw their tax payments rise by 57 percent, and their share of the tax burden climbed from 11.6 percent to 15.1 percent.[4]
- **1980s:** The Reagan years saw the top rate fall from 70 percent in 1980 to 28 percent in 1988. What happened to the rich? The top 1 percent went from shouldering 17.6 percent of the income tax burden in 1981 to paying 27.5

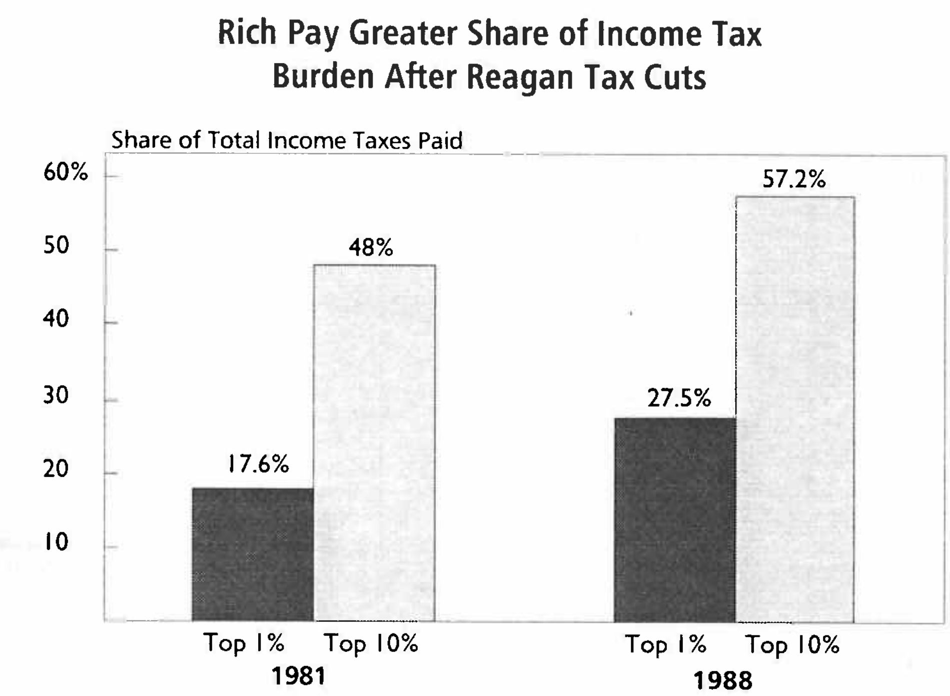
2 The goal of legislators should not be to set the rate at the revenue-maximizing level; instead, they should lower rates even further to maximize growth. Regardless of the goal, however, it is self-defeating to set the top rate above the revenue-maximizing level.

3 Joint Economic Committee, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," June 18, 1962.

4 *Ibid.*

percent of the total in 1988. The top 10 percent saw their share of the burden climb from 48 percent in 1981 to over 57 percent in 1988.[5]

Chart 2



Source: Internal Revenue Service.

Myth: Only millionaires should care about the tax-the-rich issue.

Reality: Like fairness, "rich" is a subjective term. Some in Washington, D.C., think you are wealthy if your income rises much beyond $56,200. According to a Tax Foundation analysis of Internal Revenue Service (IRS) data, the cutoff point for the top 20 percent of tax returns is $56,262. This top quintile of income earners is also the group that those who oppose pro-growth tax policies commonly refer to as the "rich." It also includes the vast majority of small businesses that use the personal income tax instead of the corporate income tax. (See Chart 3.)

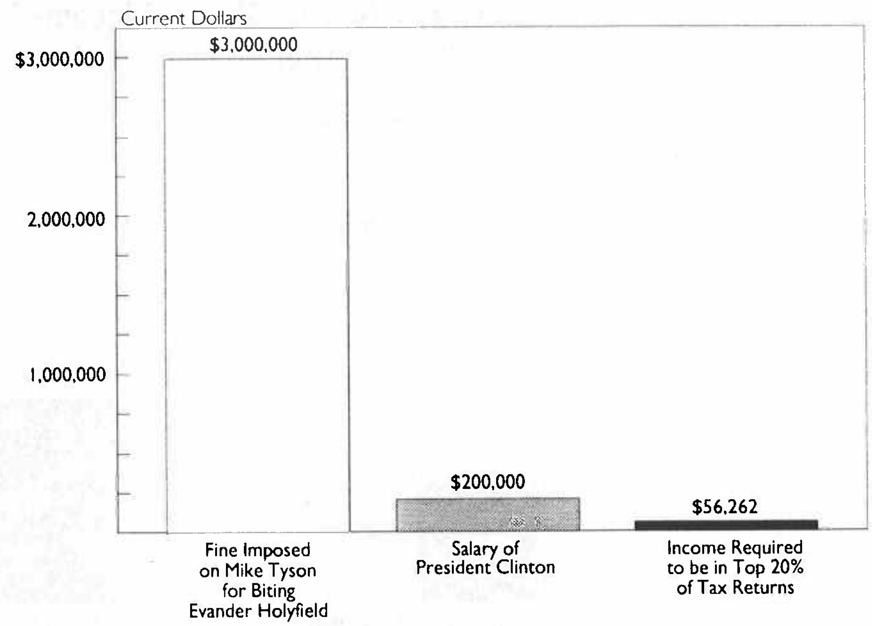
Myth: Lower tax rates mean the rich get richer and the poor get poorer.

Reality: President Kennedy was right: A rising tide lifts all boats. Census Bureau data show that earnings for all income classes tend to rise and fall in unison. In other words, economic policy either generates positive results, in which case all income classes benefit, or it causes stagnation and decline, in which case all groups suffer. As Chart 4 illustrates, the high tax policies of the late 1970s and early 1990s are associated with weak economic performance, while the low tax rates of the 1980s are correlated with rising incomes for all quintiles.

5 Daniel J. Mitchell, "The Historical Lessons of Lower Tax Rates," Heritage Foundation *Backgrounder* No. 1086, July 19, 1996, p. 7.

Chart 3

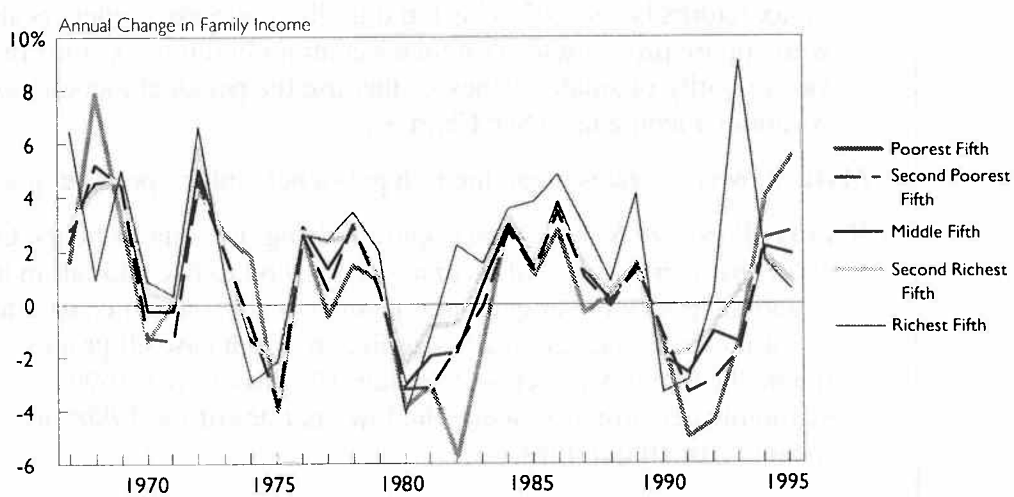
Who Is Rich? According to Liberals, the Income Required to Be "Rich" Can Be as Low as $56,262



Source: Tax Foundation calculations based on IRS data.

Chart 5

A Rising Economic Tide Lifts All Boats: Rich, Middle-Class and Poor Sink or Swim Together



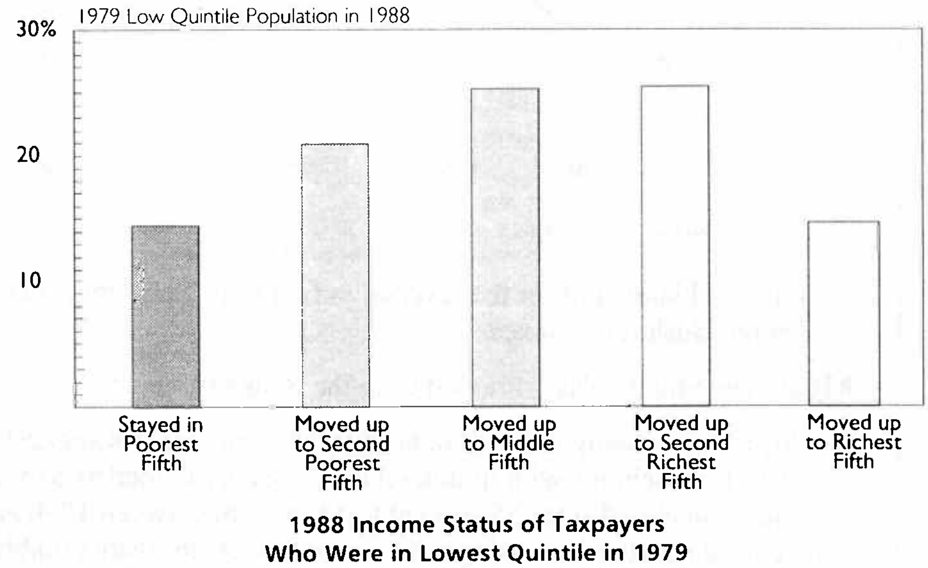
Source: Census Bureau.

Myth: The United States no longer is a land of opportunity. Those who work hard and play by the rules cannot climb the economic ladder.

Reality: President Bill Clinton's own Council of Economic Advisers reports that "studies indicate a reasonably high degree of [income] mobility over time" and that "almost two thirds of households change income quintiles over 10 years."[6] A Treasury Department study of those filing tax returns found that, over a ten-year period, the poorest 20 percent were more likely to have climbed to the top 20 percent of taxpayers than to have remained in the bottom 20 percent.[7] (See Chart 5.)

Chart 5

During the 1980s, People Who Started in the Lowest Income Quintile Were More Likely to End Up "Rich" than to Have Stayed Poor



Source: Treasury Department.

Myth: Lower tax rates will lead to a repeat of the failed policies of the 1980s.

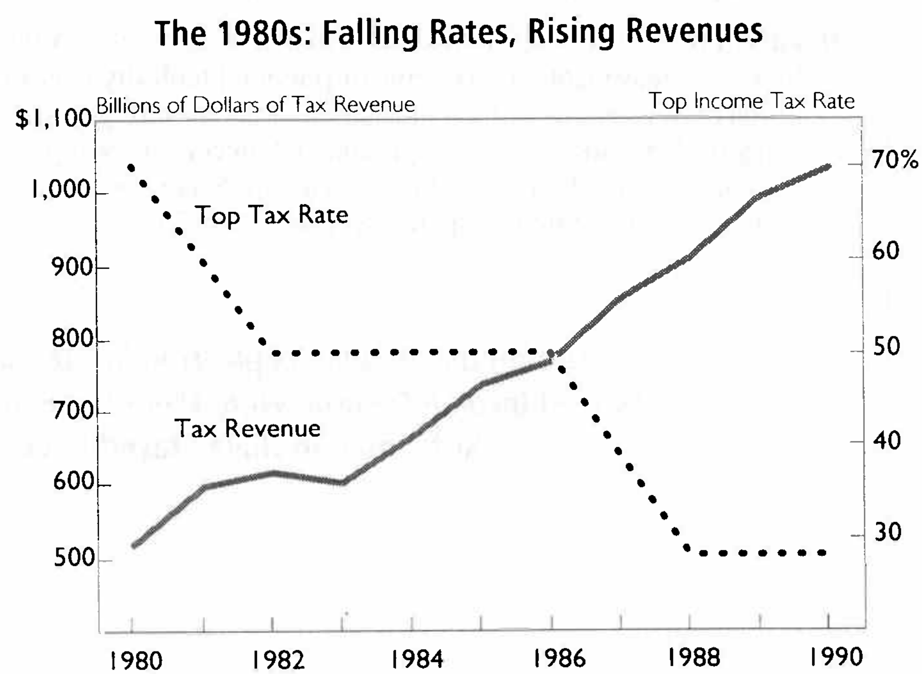
Reality: In the 1980s, tax revenues climbed by 99.4 percent, and the economy enjoyed its longest peacetime expansion in history. This is the very antithesis of failure. (See Chart 6.)

Myth: The average family's income declined during the Reagan years.

Reality: This assumes that President Ronald Reagan was responsible for the economy's miserable performance before he took office and after he left office. As Chart 7 shows, however, average family income rose substantially when the Reagan tax cuts were in effect. Incomes were falling at the end of the Carter Administration and before the tax cuts took effect, but that hardly can be blamed on President Reagan. Likewise, it is

6 *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, February 1997).
7 Staff study, "Income Mobility and Economic Opportunity," Joint Economic Committee, June 1992, available on the Internet at *http://www.house.gov/jec/middle/mobility/mobility.htm*.

Chart 6



Sources: Tax Foundation; *Budget of the U.S. Government, FY 1997,* Office of Management and Budget.

unfair to blame him for the reversal in family incomes that occurred when President George Bush raised taxes.

Myth: The middle class shrank during the Reagan years.[8]

Reality: This actually is true, but not for the reason critics suggest. The percentage of the total of households with middle-class incomes (defined as $15,000 to $50,000 in 1989 dollars) declined from 55 percent to 51 percent between 1980 and 1989, but this occurred because increasing numbers of Americans were climbing the ladder of success, not because middle-class households were becoming poorer. The percentage of households earning lower incomes also fell during the Reagan years, dropping from 27.5 percent in 1980 to 25.3 percent in 1989. This reduction in lower-income and middle-income households occurred because the over-$50,000 category expanded from 17.6 percent to 23.5 percent of households. (See Chart 8.)

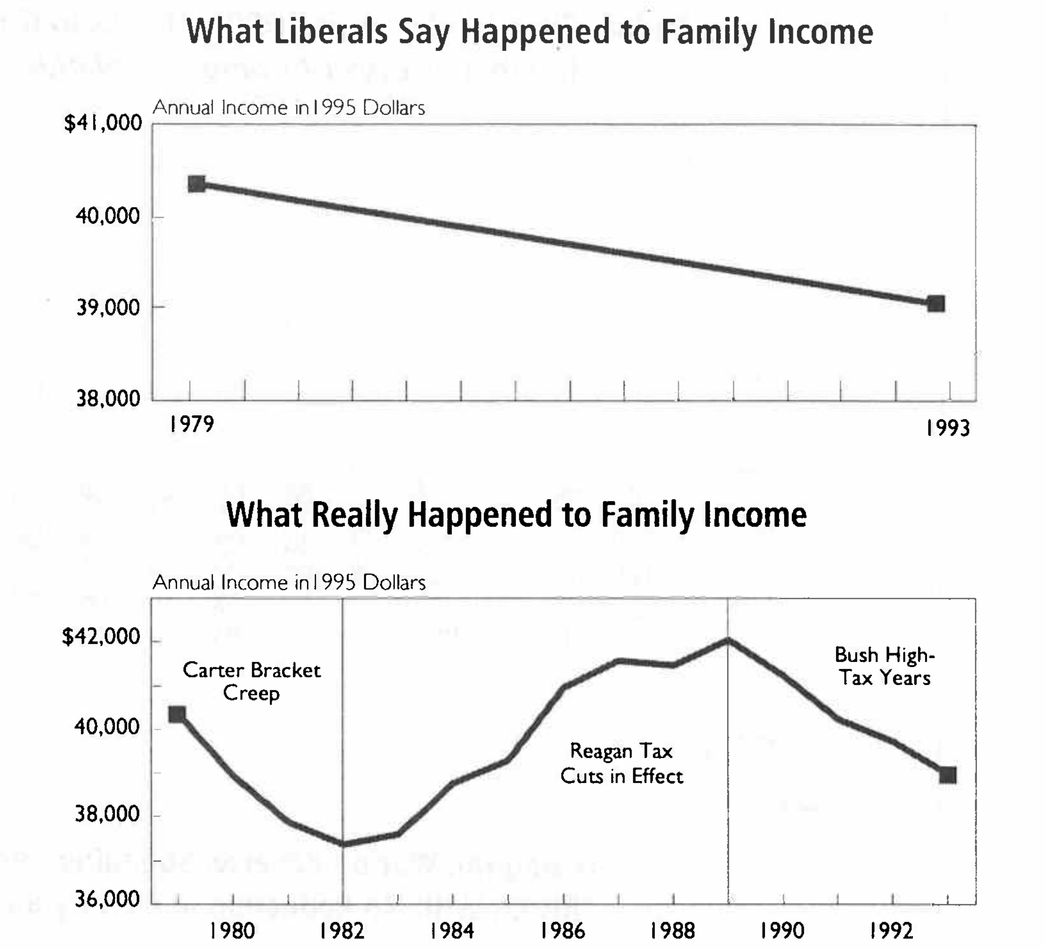
Myth: Lower tax rates deprive government of revenues needed to fund programs that help the poor.

Reality: During the past 30 years, the federal government has spent more than $5 trillion on means-tested programs. At best, this massive expenditure—in real terms, twice the U.S. cost of fighting World War II—had no effect on the poverty rate.[9] Chart 9 shows that the dramatic increases in inflation-adjusted welfare spending have not led to reductions in the poverty rate. Instead, a growing body of social science data indicates that

8 Economic Update, "The Reagan Prosperity," Joint Economic Committee, November 1995, available on the Internet at *http://www.house.gov/jec/growth/prosper/prosper.htm.*

9 Robert Rector and William F. Lauber, *America's Failed $5.4 Trillion War on Poverty* (Washington, D.C.: The Heritage Foundation, 1995).

Chart 7



Source: Census Bureau.

these programs have hindered reductions in poverty by undermining work incentives and subsidizing self-destructive behavior like having children out of wedlock.

Myth: Taxes should be higher for business and lower for people.

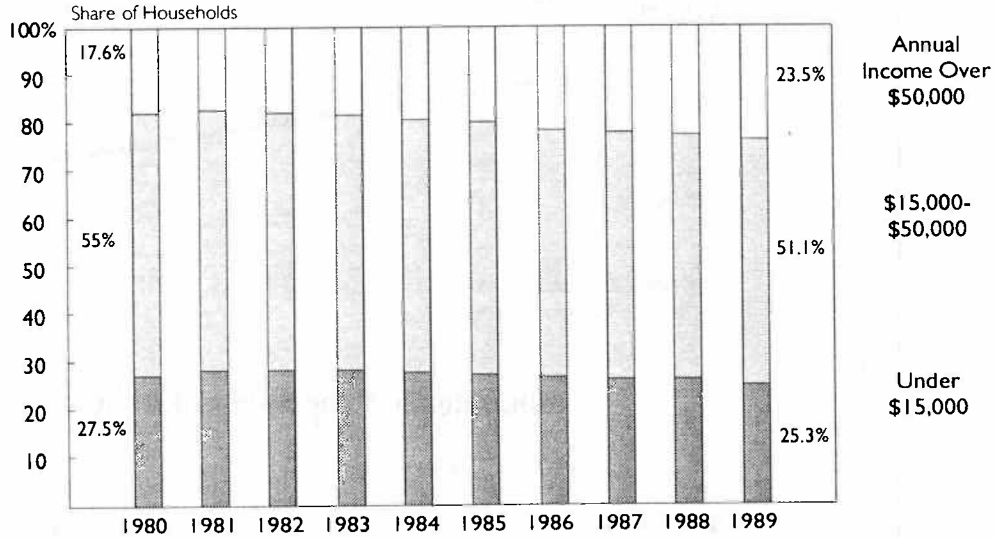
Reality: Businesses do not pay taxes; they only collect them. It is people—consumers, workers, or shareholders—who pay the taxes collected at the business level. This does not mean it is necessarily wrong to make business the collection point for taxes. For purposes of simplicity, all taxes on dividends, interest, and other forms of capital income would be collected at the business level under a flat tax, for example, and businesses would be responsible for collecting all taxes under a national retail sales tax. Supporters of tax reform, however, recognize that these taxes are still a burden that is borne by individuals.

Myth: Eliminating capital gains taxes, death taxes, the double taxation of dividends, or the double taxation of savings merely will create loopholes for the rich to exploit.

Reality: Existing provisions of the tax code dealing with capital have the effect of taxing income more than once. More specifically, they impose multiple layers of taxation on

Chart 8

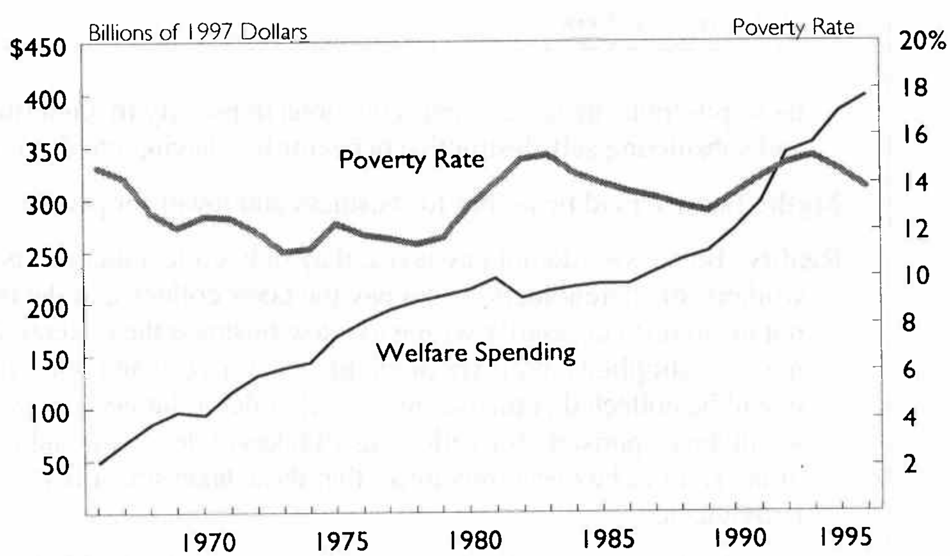
Middle Class Did Shrink in 1980s, Thanks to Growing Number of *Upper-Income Households*



Note: Income in 1989 dollars.
Source: Joint Economic Committee.

Chart 9

Losing the War on Poverty: Spending Keeps Rising With No Reduction in Poverty Rate

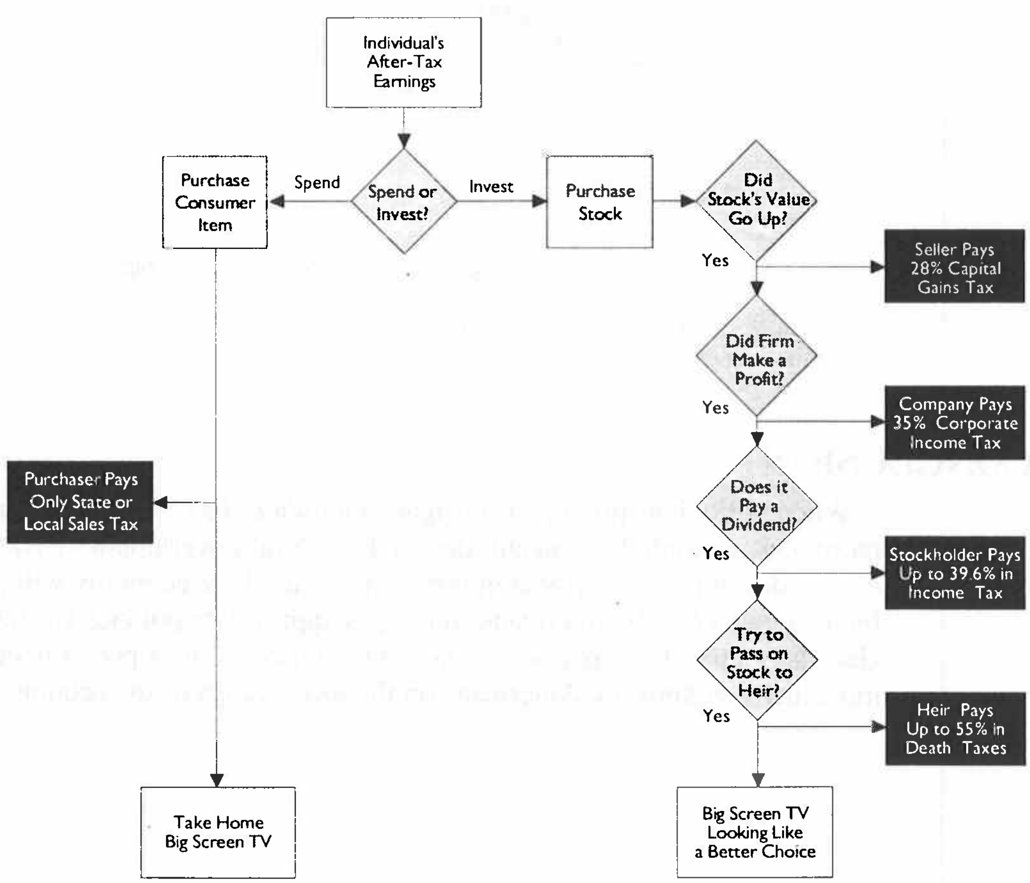


Source: Robert Rector and William F. Lauber, *America's Failed $5.4 Trillion War on Poverty*, The Heritage Foundation, 1995.

savings and investment. Defenders of the status quo can argue that these provisions are desirable. They can claim that the goal of income redistribution necessitates double taxation. They even can say there is nothing morally wrong or economically destructive about discriminating against taxpayers who save and invest. They cannot argue legitimately, however, that elimination of double taxation creates loopholes. Double taxation is a bias; adopting policies that tax income only once institutes fairness. (See Chart 10.)

Chart 10

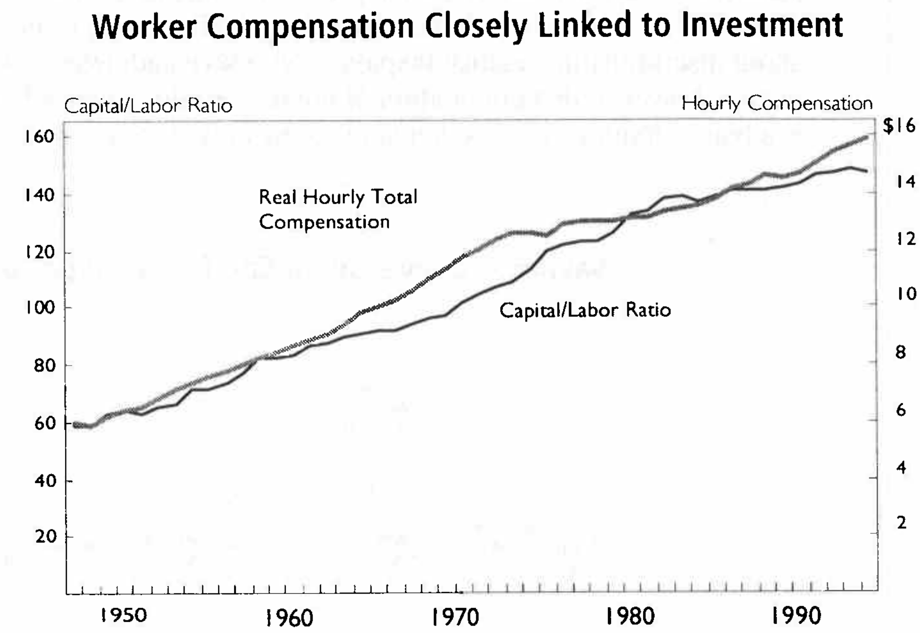
Saving and Investment Can Be Taxed up to Four Times



Myth: Lower taxes on capital—savings and investment—represent "trickle-down" economics.

Reality: Because every economic theory, including Marxism, agrees that capital formation is the key to faster growth and higher standards of living, attaching odious labels to policies designed to reduce or eliminate the tax code's bias against savings and investment is particularly counterproductive. Chart 11 illustrates that increases in real wages over time are closely correlated with the amount of capital per worker. In other words, if workers are paid on the basis of what they produce, it makes sense to adopt tax policies that encourage investment in the tools, equipment, machinery, and technology that help workers produce more.

Chart 11



Note: Capital/Labor ratio = Amount of capital per worker.
Source: Aldona and Gary Robbins, "The Truth About Falling Wages," *Economic Scorecard*, Institute for Policy Innovation, TaxAction Analysis, Third Quarter 1995.

CONCLUSION

When politicians pit one group against another, the only winners are those who believe more power should be concentrated in the federal government in Washington, D.C. The economic evidence clearly demonstrates that the U.S. economy will produce significant income gains for all Americans so long as appropriate policies are followed. When politicians adopt punitive tax policies, however, the economy's performance stumbles, and the most likely victims are Americans on the lower rungs of the economic ladder.