WebMemo
Published by The Heritage Foundation
No. 3381
October 3, 2011

The Buffett Rule: Fair to No One

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President Obama proposed $1.5 trillion in permanent tax hikes over 10 years in his latest plan to reduce the national debt. This massive tax hike would fall mostly on families and businesses earning more than $250,000 a year. The President argues that these job creators should pay higher taxes out of "fairness."

But fairness is a poor metric to evaluate tax policy. It is more important to focus on how much tax high-earning families and businesses already pay and if forcing them to pay more would in fact be fair to those who would bear the steep burden of the tax hikes.

High-Earners Already Pay Vast Majority of Taxes. To President Obama, it is "fair" to raise taxes on families and businesses earning more than $250,000 a year by raising their income tax rates and limiting their deductions. That must also mean he believes that they currently pay too little in taxes.

Yet the data show the highest-earning families and businesses already pay the lion's share of the federal income tax burden. According to the IRS, the top 1 percent of income earners—those earning more than $380,000 in 2008—paid more than 38 percent of all federal income taxes while earning 20 percent of all income. The top 10 percent ($114,000 and above) earned 45 percent of income and paid 70 percent of all taxes. At the same time, the bottom 50 percent of income earners—those earning less than $33,000—earned 13 percent of all income and paid less than 3 percent of federal income taxes.[1]

High earners pay a large majority of the income tax burden because of the progressive federal income tax that levies higher marginal tax rates as income rises.

As a way to compare the current tax code to a better system, under a flat tax, the top 1 percent of earners would pay 20 percent of the tax burden—equal to the proportion of the nation's income that they earned. The same applies to other income classifications.

While almost everyone should pay at least some federal income tax so they have some stake in controlling the size of the federal government, it is reasonable to exempt the poorest Americans from the levy. An improved income tax can both achieve a more equitable distribution of the tax burden and exempt low-income families at the same time.

Yet President Obama's tax hikes would increase the tax burden at the highest income levels and lower it for those below. In the process, these hikes would move the tax code even further away from a neutral distribution of the tax burden.

Higher Taxes on Job Creators. The President's tax hikes on the rich would result in fewer jobs for all Americans, including middle- and low-income

This paper, in its entirety, can be found at:
http://report.heritage.org/wm3381

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
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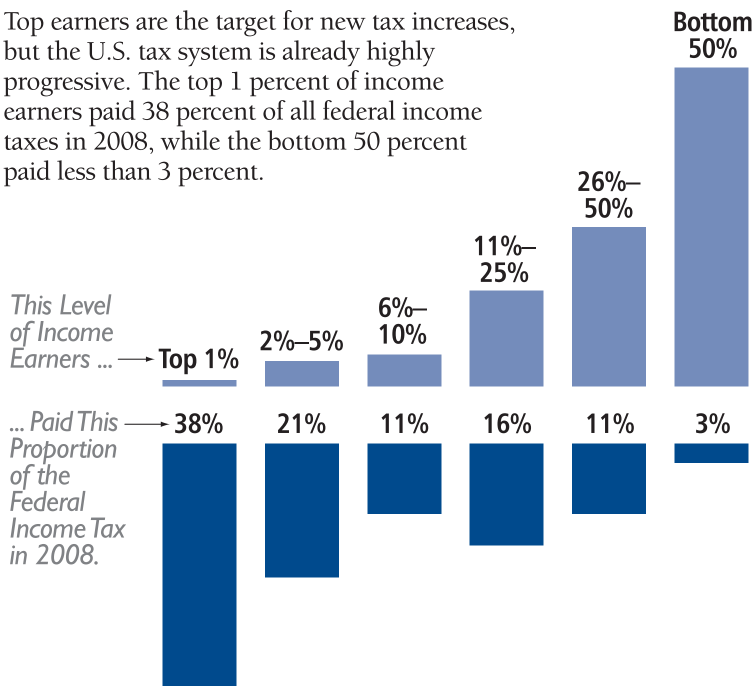
The Top 10 Percent of Earners Paid 70 Percent of Federal Income Taxes

Top earners are the target for new tax increases, but the U.S. tax system is already highly progressive. The top 1 percent of income earners paid 38 percent of all federal income taxes in 2008, while the bottom 50 percent paid less than 3 percent.



Sources: Tax Foundation, "Summary of Latest Federal Individual Income Tax Data," October 6, 2010, at *http://www.taxfoundation.org/news/show/250.html* (October 3, 2011); Internal Revenue Service, "SOI Tax Stats–Individual Statistical Tables by Tax Rate and Income Percentile," at *http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html* (October 3, 2011).

Chart 1 • WM 3381 heritage.org

workers. The families, individuals, and businesses that would pay an even higher share of the tax burden under the President's plan are the job creators the economy needs to start hiring to lower the unemployment rate to acceptable levels.

This group includes investors, the lifeblood of the economy, who provide the capital for businesses to expand and add new workers and for entrepreneurs to start new enterprises. Raising their taxes reduces their incentives to provide these vital sources of funding to businesses and start-ups—and, therefore, the businesses' ability to create new jobs.

Many businesses pay their taxes through their owners' individual income tax returns. The President's tax hikes would be a direct tax on these important employers. A recent study from President Obama's own Treasury Department shows that 90 percent of businesses that pay taxes through the individual income tax code and employ workers would pay the higher taxes under the President's plan.[2] Higher taxes would reduce these businesses' incentives to hire new workers and their ability to retain or increase compensation for their existing employees.

Buffett Rule Already in Effect. In a further effort to ostensibly improve the fairness of the tax code, President Obama formulated the "Buffett Rule," named after famed billionaire investor Warren Buffett, who often calls for higher taxes on the rich. According to the Buffett Rule, families and small businesses making more than $1 million should not pay a smaller share of their income in taxes than a middle-income family.

The Buffett Rule is unnecessary because top-earners, including billionaires like Buffett, already pay much higher taxes as a share of their income than middle-income families. In fact, they pay an effective tax rate that is more than double the rate paid by middle-income families. According to the Congressional Budget Office, the top 1 percent of income earners pay more than 30 percent of their income in federal taxes. Middle-income families pay less than 15 percent.[3]

In fact, the Buffett Rule is just a new twist on an already-existing policy to ensure that the wealthy

1. U.S. Department of Treasury, Internal Revenue Service, *Individual Income Tax Rates and Shares*, 2008, Winter 2011, at *http://www.irs.gov/pub/irs-soi/11intr08winbul.pdf* (September 20, 2011).
2. U.S. Department of the Treasury, *Methodology to Identify Small Businesses and Their Owners*, August 2011, table 15, at *http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf* (September 14, 2011).
3. Congressional Budget Office, "Average Federal Tax Rates for All Households, by Comprehensive Household Income Quintile, 1979–2007," at *http://www.cbo.gov/publications/collections/tax/2010/average_rates.pdf* (September 27, 2011).

pay their "fair share." Congress passed the Alternative Minimum Tax (AMT) in the early 1970s to ensure that a few high-income taxpayers did not reduce their tax liability too much by taking advantage of all the deductions, exemptions, and credits Congress put in the tax code. But Congress did not index for inflation the income threshold over which families qualify for this extra tax. So now Congress must annually "patch" the AMT by raising the threshold to correct this mistake.[4] Even with the patch, the AMT still ends up falling on almost 4 million taxpayers; Congress initially intended for it to hit only a few hundred.

The AMT is a policy failure. Congress should not compound it by adding a new Buffett Rule on top of it.

Steep Capital Gains Hike. The Buffett Rule is largely undefined in the President's plan, so taxpayers and lawmakers must speculate on how it would work. Instead of raising the share of federal taxes paid by millionaires, it could raise the capital gains tax rate so it is equal to, or higher than, middle-class income tax rates—28 percent or higher.

President Obama has stated his intention to return income tax rates to their levels prior to the Bush tax cuts. This, combined with the Buffett Rule, could raise the capital gains tax rate from 15 percent to as high as 39.6 percent.

This would prove highly damaging. A higher capital gains rate would make it more expensive for businesses to purchase new equipment, machinery, tools, property, and other assets they need to grow and to add new workers or to improve current workers' productivity so they can pay them more. Increased costs would force them to cut back on these vital purchases. The end result would be fewer jobs and lower wages for many middle- and low-income families. This is the exact opposite of sound tax reform, which would lower the cost of capital.

Truly Fair Tax Reform. If Warren Buffett thinks he is under-taxed, he can pay more any time. All he has to do is write a check to the Treasury Department at this Web site: *http://www.treasurydirect.gov/govt/reports/pd/gift/gift.htm*.

It would be "fairer" if he and President Obama stopped trying to hike taxes and focused on true tax reform that would benefit all Americans.

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4. J. D. Foster, "Making Good Policy Out of a Bad AMT," Heritage Foundation *Backgrounder* No. 2082, October 31, 2007, at *http://www.heritage.org/Research/Reports/2007/10/Making-Good-Policy-Out-of-a-Bad-AMT.*