

Is Our Tax System Helping Us Create Wealth?

By David Cay Johnston

David Cay Johnston is a former tax reporter for *The New York Times*. He teaches at Syracuse University College of Law and is the author of two books about taxes, *Free Lunch* and *Perfectly Legal*.

Johnston compares tax burdens in 1961 and 2006 at the very top income levels and for the vast majority of taxpayers and asks whether tax policy is improving wealth creation and social stability.

Imagine that all you had to live on was the amount of tax you saved in your best year because of the many tax rate cuts Congress has put in place since 1964, when President Johnson signed into law the Kennedy tax cuts.

For most Americans, living off income tax savings would mean starvation. Their income tax savings have been minor, and when looked at over a long period, say since 1961, increases in payroll taxes have more than offset their slight income tax reductions.

But for the very few who have gained the most from living in the United States, the story is quite different. Their tax savings alone from a single year, invested to earn just 5 percent annually, would be enough to provide a lifetime income at nearly twice the income threshold for being in the top tenth of 1 percent.

I cite the year 1961 because of a quirk in the *Statistics of Income* report for that year that makes it easy to compare those at the very top with the bottom 90 percent of Americans.

We have data on the 400 highest-income taxpayers only from 1992 to 2006, and then only thanks to Joel Slemrod of the University of Michigan and others who had these data analyzed, and the Obama administration, which overturned the George W. Bush policy of treating the data as a state secret.

However, it turns out that in 1961, the top income category in the SOI report was \$1 million of adjusted gross income. That year, 398 taxpayers reported making \$1 million or more.

So by comparing the average income of the top 398, and the taxes they paid, with 2006 dollars, we can compare how people at the apex of the economy were doing 45 years apart. And then by looking at the bottom 90 percent of taxpayers in 1961 and 2006, we can compare the very top with the rest of taxpayers.

The vast majority of Americans saw their incomes rise only modestly in those 45 years. Measured in 2006

dollars, the average income of the bottom 90 percent grew from \$22,366 in 1961 to \$31,642 in 2006.

That is a real increase of \$9,276 in average income. But it was also after 45 years, longer than the careers of most workers. In calculating old-age benefits, Social Security counts only the top 35 years.

That \$9,276 increase means that for each dollar the vast majority of Americans earned in 1961, they earned \$1.41 in 2006. That is the equivalent of coming to work each January 2 and being told that your gross pay will increase by inflation plus \$3.96 per week.

Those at the 90th rung on the income ladder did better than the average of the bottom 90 percent. The ceiling for the bottom 90 percent rose from \$60,404 in 1961 to \$104,440 in 2006. That is the equivalent of an annual raise of inflation plus \$1,000, or \$19 per week.

For the vast majority, federal income taxes declined. In 1961 these people paid on average 9.6 percent of their income to the federal government. By 2006 this burden had been cut to 7.2 percent. That tax rate reduction saved each of these taxpayers about \$760, assuming the 1961 tax rates had remained the same in 2006.

That tiny increase in pay does not represent a real increase in wages, only total income. That is because in the middle of that 45-year era, a profound transformation took place in America.

In 1961 most families lived on one income, maybe supplemented by some part-time work by the wife for what was quaintly known back then as "pin money." Now two-income households are the norm.

The overall wealth of America grew and grew during this era. GDP, adjusted for inflation and increased population, was up 227 percent. But wages and fringe benefits did not grow with the economy. For most workers, they fell. Wages peaked way back in 1972-1973, were on a mostly flat trajectory for more than two decades, rose briefly in the late 1990s, and then fell sharply in the new century. Airline pilots have seen their 1990s income cut by more than half; some union factory workers have seen their pay slashed by two-thirds. Millions are out of work, and the jobs they once held are gone and are not coming back. And even if the Great Recession is coming to an end, we face years of jobs growing more slowly than the working-age population, which could radically transform America's culture, work ethic, and sense of progress.

In 2006 families worked on average about 900 more hours than families did in the 1960s and early 1970s. That is a roughly 45 percent increase in hours worked accompanied by a 41 percent increase in total income.

For many, the reality is that two jobs produce the same or a smaller after-tax income than just one job did three and four decades ago.

The income tax savings, equal to 2.4 percentage points of income, statistically went to parents with children. A

Comparing Income Growth and Income Tax Burdens in 1961 and 2006					
		2006	1961	Change	Ratio
Top 398/Top 400	Income	\$263,300,000	\$13,676,287	\$249,623,713	19.3
	Income tax	\$45,204,640	\$5,800,515	\$39,404,125	7.8
	After-tax income	\$218,095,360	\$7,875,772	\$210,219,588	27.7
	Effective tax rate	17.17%	42.41%	-25.2% points	-60%
	Tax at 1961 rate	\$111,673,263			
	Tax savings	\$66,468,623			
Bottom 90 percent	Income	\$31,642	\$22,366	\$9,276	1.4
	Income tax	\$2,278	\$2,147	\$131	1.1
	After-tax income	\$29,364	\$20,219	\$9,145	1.5
	Effective tax rate	7.20%	9.60%	-2.4% points	-20%
	Tax at 1961 rate	\$3,038			
	Tax savings	\$759			

Source: IRS Statistics of Income Division for 398/400; Picketty and Saez analysis of IRS data for bottom 90 percent.

\$500 per-child tax credit, sponsored by Republicans in Congress, was enacted in 1997 and signed by President Clinton. President Bush and Congress doubled the credit in 2001. The result was that a couple with two children who made more than \$40,000 that year paid no income taxes, while a single person who filed a simple tax return on \$40,000 of income paid almost \$5,600, or about 14 percent of their income.

During the 45 years starting in 1961, payroll taxes have gone from a minor levy to almost a sixth of wages for the bottom 90 percent of American households. This \$760 in income tax savings that the average taxpayer enjoyed in 2006 was taken back, and more, by the increased tax rates for Social Security and Medicare. Those rates rose from 3 percent withheld from pay in 1961 to 7.65 percent in 2006. Not all income is from wages, of course, but those higher payroll taxes wiped out the seeming reduction in the income tax and more.

So figure that for each dollar the vast majority had to spend after taxes in 1961, the vast majority in 2006 had that buck and four more dimes after income and payroll taxes.

And at the top? Now, that's a different story.

The average income for the top 400 taxpayers rose over the 45 years from \$13.7 million to \$263.3 million. That is 19.3 times more.

The income tax bill went up too, but only 7.8 times as much because tax rates plunged. Income tax rates at the top fell 60 percent, three times the percentage rate drop for the vast majority. And at the top, the savings were not offset by higher payroll taxes, which are insignificant to top taxpayers.

The average income tax rate for those at the top in 1961 was 42.4 percent. By 2006 it was down to 17.17 percent. Add on payroll taxes, and the 2006 rate is 17.2 percent, the same as rounding the income tax figure alone.

This combination of explosive growth in income and a 60 percent cut in effective tax rates meant that average after-tax income rose to \$210 million in 2006, compared with \$7.9 million in 1961.

That means that for every dollar those at the top had after taxes in 1961, they had \$27.70 in 2005.

During the period when the vast majority had an extra four dimes to each \$27.70, for those at the top, the economy grew, per person, 227 percent.

Without a doubt, the much lower tax rates at the top encouraged people to realize more income in the tax system. And if the only measure is that some people made more, then this would be a good.

But let's ask the question that the classical economists would have asked back when they were known as moral philosophers and their leaders spoke of policies that benefited the majority. Let's go back to a time before Vilfredo Pareto's observations began what is the overwhelmingly dominant orthodoxy today, *neoclassical* economics with its focus on gain.

What is the social utility of creating a society whose rules generate a doubling of output per person but provide those at the top with 37 times the gain of the vast majority? Adam Smith taught that whatever was beneficial to the majority must be good policy. So did Jeremy Bentham.

Is a ratio of gain of 37 to 1 from the top to the vast majority beneficial? Is it optimal? Does it provide the development, support, and initiative to maximize the nation's gain? Are we to think that the gains of the top 398 or 400 taxpayers are proportionate to their economic contributions? Does anyone really think that heavily leveraged, offshore hedge fund investments are creating wealth, rather than just exploiting rules to concentrate wealth, while shifting risks to everyone else?

Under the overwhelmingly dominant economic theory of today, this is all good. Pareto argued that if no one was harmed, then all gain was good.

Carried to an extreme, neoclassical economics would say that if the bottom 99.9999997 percent had the same income in 1961 and 2006, and all of the gain went to the one other person in America, that would be a good.

So back to the original question: Imagine that all you had to live on was the amount of tax you saved in your best year because of the many tax rate cuts Congress has put in place since 1964. If you were in the vast majority, you would have, ignoring the payroll tax offsets, less than \$800. If that were invested at 5 percent, you would have about \$3 a month to spend. You would starve.

If you were in the top group in just one year your tax savings would be \$66.5 million. Invested at 5 percent, that tax savings would throw off more than \$247,000 a month, which is well above the threshold (about \$159,000 a month in 2006) to remain in the top tenth of 1 percent income class.

Is our tax system helping us create wealth and build a stable society? Or is it breeding deep problems by redistributing benefits to the top while maintaining burdens for the rest of Americans?

Think about that in terms of this stunning fact teased from the latest Federal Reserve data by Barry Bosworth and Rosanna Smart for the Brookings Institution: The average net worth of middle-income families with children whose head is age 50 or younger, is smaller today than it was in 1983.

Your thoughts? E-mail me at JohnstonsTake@tax.org.