A Tax System Stacked Against the 99 Percent

By Joseph E. Stiglitz, The New York Times

16 April 13

EONA HELMSLEY, the hotel chain executive who was convicted of federal tax evasion in 1989, was notorious for, among other things, reportedly having said that "only the little people pay taxes."

As a statement of principle, the quotation may well have earned Mrs. Helmsley, who died in 2007, the title Queen of Mean. But as a prediction about the fairness of American tax policy, Mrs. Helmsley's remark might actually have been prescient.

Today, the deadline for filing individual income-tax returns, is a day when Americans would do well to pause and reflect on our tax system and the society it creates. No one enjoys paying taxes, and yet all but the extreme libertarians agree, as Oliver Wendell Holmes said, that taxes are the price we pay for civilized society. But in recent decades, the burden for paying that price has been distributed in increasingly unfair ways.

About 6 in 10 of us believe that the tax system is unfair - and they're right: put simply, the very rich don't pay their fair share. The richest 400 individual taxpayers, with an average income of more than $200 million, pay less than 20 percent of their income in taxes - far lower than mere millionaires, who pay about 25 percent of their income in taxes, and about the same as those earning a mere $200,000 to $500,000. And in 2009, 116 of the top 400 earners - almost a third - paid less than 15 percent of their income in taxes.

Conservatives like to point out that the richest Americans' tax payments make up a large portion of total receipts. This is true, as well it should be in any tax system that is progressive - that is, a system that taxes the affluent at higher rates than those of modest means. It's also true that as the wealthiest Americans' incomes have skyrocketed in recent years, their total tax payments have grown. This would be so even if we had a single flat income-tax rate across the board.

What should shock and outrage us is that as the top 1 percent has grown extremely rich, the effective tax rates they pay have markedly decreased. Our tax system is much less progressive than it was for much of the 20th century. The top marginal income tax rate peaked at 94 percent during World War II and remained at 70 percent through the 1960s and 1970s; it is now 39.6 percent. Tax fairness has gotten much worse in the 30 years since the Reagan "revolution" of the 1980s.

Citizens for Tax Justice, an organization that advocates for a more progressive tax system, has estimated that, when federal, state and local taxes are taken into account, the top 1 percent paid only slightly more than 20 percent of all American taxes in 2010 - about the same as the share of income they took home, an outcome that is not progressive at all.

With such low effective tax rates - and, importantly, the low tax rate of 20 percent on income from capital gains - it's not a huge surprise that the share of income going to the top 1 percent has doubled since 1979, and that the share going to the top 0.1 percent has almost tripled, according to the economists Thomas Piketty and Emmanuel Saez. Recall that the wealthiest 1 percent of Americans own about 40 percent of the nation's wealth, and the picture becomes even more disturbing.

If these numbers still don't impress you as being unfair, consider them in comparison with other wealthy countries.

The United States stands out among the countries of the Organization for Economic Cooperation and Development, the world's club of rich nations, for its low top marginal income tax rate. These low rates are not essential for growth - consider Germany, for instance, which has managed to maintain its status as a center of advanced manufacturing, even though its top income-tax rate exceeds America's by a considerable margin. And in general, our top tax rate kicks in at much higher incomes. Denmark, for example, has a top tax rate of more than 60 percent, but that applies to anyone making more than $54,900. The top rate in the United States, 39.6 percent, doesn't kick in until individual income reaches $400,000 (or $450,000 for a couple). Only three O.E.C.D. countries - South Korea, Canada and Spain - have higher thresholds.

Most of the Western world has experienced an increase in inequality in recent decades, though not as much as the United States has. But among most economists there is a general understanding that a country with excessive inequality can't function well; many countries have used their tax codes to help "correct" the market's distribution of wealth and income. The United States hasn't - or at least not very much. Indeed, the low rates at the top serve to exacerbate and perpetuate the inequality - so much so that among the advanced industrial countries, America now has the highest income inequality and the least equality of opportunity. This is a gross inversion of America's traditional meritocratic ideals - ideals that our leaders, across the spectrum, continue to profess.

Over the years, some of the wealthy have been enormously successful in getting special treatment, shifting an ever greater share of the burden of financing the country's expenditures - defense, education, social programs - onto others. Ironically, this is especially true of some of our multinational corporations, which call on the federal government to negotiate favorable trade treaties that allow them easy entry into foreign markets and to defend their commercial interests around the world, but then use these foreign bases to avoid paying taxes.

General Electric has become the symbol for multinational corporations that have their headquarters in the United States but pay almost no taxes - its effective corporate-tax rate averaged less than 2 percent from 2002 to 2012 - just as Mitt Romney, the Republican presidential nominee last year, became the symbol for the wealthy who don't pay their fair share when he admitted that he paid only 14 percent of his income in taxes in 2011, even as he notoriously complained that 47 percent of Americans were freeloaders. Neither G.E. nor Mr. Romney has, to my knowledge, broken any tax laws, but the sparse taxes they've paid violate most Americans' basic sense of fairness.

In looking at such statistics, one has to be careful: they typically reflect taxes as a percentage of reported income. And the tax laws don't require the reporting of all kinds of income. For the rich, hiding such assets has become an elite sport. Many avail themselves of the Cayman Islands or other offshore tax shelters to avoid taxes (and not, you can safely assume, because of the sunny weather). They don't have to report income until it is brought back ("repatriated") to the United States. So, too, capital gains have to be reported as income only when they are realized.

And if the assets are passed on to one's children or grandchildren at death, no taxes are ever paid, in a peculiar loophole called the "step-up in cost basis at death." Yes, the tax privileges of being rich in America extend into the afterlife.

As Americans look at some of the special provisions in the tax code - for vacation homes, racetracks, beer breweries, oil refineries, hedge funds and movie studios, among many other favored assets or industries - it is no wonder that they feel disillusioned with a tax system that is so riddled with special rewards. Most of these tax-code loopholes and giveaways did not materialize from thin air, of course - usually, they were enacted in pursuit of, or at least in response to, campaign contributions from influential donors. It is estimated that these kinds of special tax provisions amount to some $123 billion a year, and that the price tag for offshore tax loopholes is not far behind. Eliminating these provisions alone would go a long way toward meeting deficit-reduction targets called for by fiscal conservatives who worry about the size of the public debt.

Yet another source of unfairness is the tax treatment on so-called carried interest. Some Wall Street financiers are able to pay taxes at lower capital gains tax rates on income that comes from managing assets for private equity funds or hedge funds. But why should managing financial assets be treated any differently from managing people, or making discoveries? Of course, those in finance say they are essential. But so are doctors, lawyers, teachers and everyone else who contributes to making our complex society work. They say they are necessary for job creation. But in fact, many of the private equity firms that have excelled in exploiting the carried interest loophole are actually job destroyers; they excel in restructuring firms to "save" on labor costs, often by moving jobs abroad.

Economists often eschew the word "fair" - fairness, like beauty, is in the eye of the beholder. But the unfairness of the American tax system has gotten so great that it's dishonest to apply any other label to it.

Traditionally, economists have focused less on issues of equality than on the more mundane issues of growth and efficiency. But here again, our tax system comes in with low marks. Our growth was higher in the era of high top marginal tax rates than it has been since 1980. Economists - even at traditional, conservative international institutions like the International Monetary Fund - have come to realize that excessive inequality is bad for growth and stability. The tax system can play an important role in moderating the degree of inequality. Ours, however, does remarkably little about it.

One of the reasons for our poor economic performance is the large distortion in our economy caused by the tax system. The one thing economists agree on is that incentives matter - if you lower taxes on speculation, say, you will get more speculation. We've drawn our most talented young people into financial shenanigans, rather than into creating real businesses, making real discoveries, providing real services to others. More efforts go into "rent-seeking" - getting a larger slice of the country's economic pie - than into enlarging the size of the pie.

Research in recent years has linked the tax rates, sluggish growth and rising inequality. Remember, the low tax rates at the top were supposed to spur savings and hard work, and thus economic growth. They didn't. Indeed, the household savings rate fell to a record level of near zero after President George W. Bush's two rounds of cuts, in 2001 and 2003, on taxes on dividends and capital gains. What low tax rates at the top did do was increase the return on rent-seeking. It flourished, which meant that growth slowed and inequality grew. This is a pattern that has now been observed across countries. Contrary to the warnings of those who want to preserve their privileges, countries that have increased their top tax bracket have not grown more slowly. Another piece of evidence is here at home: if the efforts at the top were resulting in our entire economic engine's doing better, we would expect everyone to benefit. If they were engaged in rent-seeking, as their incomes increased, we'd expect that of others to decrease. And that's exactly what's been happening. Incomes in the middle, and even the bottom, have been stagnating or falling.

Aside from the evidence, there is a strong intuitive case to be made for the idea that tax rates have encouraged rent-seeking at the expense of wealth creation. There is an intrinsic satisfaction in creating a new business, in expanding the horizons of our knowledge, and in helping others. By contrast, it is unpleasant to spend one's days fine-tuning dishonest and deceptive practices that siphon money off the poor, as was common in the financial sector before the 2007-8 financial crisis. I believe that a vast majority of Americans would, all things being equal, choose the former over the latter. But our tax system tilts the field. It increases the net returns from engaging in some of these intrinsically distasteful activities, and it has helped us become a rent-seeking society.

It doesn't have to be this way. We could have a much simpler tax system without all the distortions - a society where those who clip coupons for a living pay the same taxes as someone with the same income who works in a factory; where someone who earns his income from saving companies pays the same tax as a doctor who makes the income by saving lives; where someone who earns his income from financial innovations pays the same taxes as a someone who does research to create real innovations that transform our economy and society. We could have a tax system that encourages good things like hard work and thrift and discourages bad things, like rent-seeking, gambling, financial speculation and pollution. Such a tax system could raise far more money than the current one - we wouldn't have to go through all the wrangling we've been going through with sequestration, fiscal cliffs and threats to end Medicare and Social Security as we know it. We would be in sound fiscal position, for at least the next quarter-century.

The consequences of our broken tax system are not just economic. Our tax system relies heavily on voluntary compliance. But if citizens believe that the tax system is unfair, this voluntary compliance will not be forthcoming. More broadly, government plays an important role not just in social protection, but in making investments in infrastructure, technology, education and health. Without such investments, our economy will be weaker, and our economic growth slower.

Society can't function well without a minimal sense of national solidarity and cohesion, and that sense of shared purpose also rests on a fair tax system. If Americans believe that government is unfair - that ours is a government of the 1 percent, for the 1 percent, and by the 1 percent - then faith in our democracy will surely perish.