It's All Very Taxing

Today's Outside the Box is something a little different for me. Howard Marks of Oaktree Capital Management has produced a most excellent summary of the problems inherent in "all things taxing" in the US. He delves into not only the specifics but also some of the philosophy of taxation. This is a balanced piece in which he tries to present all sides and arguments, giving us a very real picture of the dilemma we face, and leaving us to draw our own conclusions. Whatever we do going forward, including nothing, the outcome with regard to taxes is going to be difficult if not painful for most of us. We talk about everyone paying their fair share, but what does that mean? The answer is that it means very different things to different people.

This goes hand in hand with my contention that we face very difficult choices, and none of them are pain-free. I have my preferred methods and choices, and you have yours, and your neighbors have yet more divergent views. But we must make the tough decisions, or the market is going to treat us as roughly as it is Italian debt. If we let it get to that point, the choices will be even more limited and painful.

This is a longer than usual OTB but it is very good, and I suggest you send it on to others, as it provides a framework for discussion and understanding the positions that others in our society might take – people of good will but with different understandings of how the world works and what is "fair." Often, their views will not be based on the same rationale as yours or mine, and thus they will come to different conclusions. But soon we will all make some very important decisions (at the polls) about who will make those decisions for us. Let's choose wisely.

Right now, I am going to choose to hit the send button and go along with my daughter Tiffani to dinner with Art Cashin, Rich Yamarone, and Barry Ritholtz, and see what wisdom they may impart. With Art, you can always count on learning something, and on hearing some wonderful stories. I am sure we will also debate the end of the euro, among other pleasant dinner topics. I live for such moments. I will report back.

Your enjoying a beautiful day in New York City analyst,

John Mauldin, Editor
Outside the Box

It's All Very Taxing

By Howard Marks
November 16, 2011

The issue is simple: the U.S. government generally spends more than it brings in . . . and recently, a lot more. For years Congress was willing to serially raise the federal debt ceiling and monetize the deficit. But this past summer, some legislators balked. When the early August deadline for an increase in the ceiling arrived, our elected officials kicked the can down the road, but less far than usual. They created a Congressional supercommittee with unprecedented power to propose solutions, and they designed automatic spending cuts in case no proposal won approval.

With the committee working under a November 23 deadline to find ways to reduce the federal deficit by $1 trillion-plus over the next decade, and with a presidential election less than a year away, the subject of taxes is all over the headlines and likely to remain there. Thus I've decided to provide a background piece on the issues.

What form will the deficit-cutting action take? In fact, the possibilities fall into only four categories:

- cut discretionary spending,
- reduce expenditures on entitlements,
- cut waste and fraud, or
- increase tax revenues.

Given the magnitude of the problem, the limited number of potential solutions, and the differences between the parties on the subject, there's already debate regarding the fourth of those listed above. Democrats generally feel tax increases should be part of any solution, and Republicans often insist that while they're open to overhauling the tax code, total taxes must not rise.

<u>What's Fair is Fair</u>

This memo got its start as an excuse for me to write about one of my greatest pet peeves: the so-called "fair share."

Ask your typical Democrat or liberal about the idea of increasing taxes on upper-bracket earners, and what will they say? In my experience, the answer's always the same: "**We're not out to soak the rich. We just want them to pay their fair share.**" We've seen it over and over for years. For example:

> Were [the politicians levying taxes on Americans] seeking to redistribute wealth, to recast society along more egalitarian lines? Or were they simply trying to ensure that rich people paid **their "fair share**"? The answer, predictably, is both. . . .
>
> If poor and middle class Americans were going to be asked [by President Roosevelt], of necessity, to shoulder much of the fiscal burden, then they needed assurance the rich were **paying their share**. . . .
>
> No one made the case more succinctly than Rep. Cordell Hull, legislative father of the 1913 income tax. "I have no disposition to tax wealth unnecessarily or unjustly," he explained in his memoirs. "But I do believe that the wealth of the country should bear **its just share** of the burden of taxation and that it should not be permitted to shirk that duty."
>
> ("Soaking the Wealthy: An American Tradition" *The Wall Street Journal*, January 29-30, 2011)

The rhetoric remained unchanged in the late twentieth century:

> "We will lower the tax burden on middle class Americans," [Bill Clinton] pledged in 1992, "by asking the very wealthy to pay **their fair share**." ("The Middle-Class Tax Trap" *The New York Times*, April 17, 2011)

More recently, President Obama carried on the tradition.

> I will veto any bill that changes benefits for those who rely on Medicare but does not raise serious revenues by asking the wealthiest Americans or biggest corporations to pay **their fair share**. (*The New York Times*, September 20, 2011)

And here's another reference from just a month ago:

> In proposing a 5 percent surtax on incomes of more than $1 million a year to pay for job-creation measures sought by President Obama, Senate Democratic leaders on Wednesday escalated efforts to strike a more populist tone and to draw Republicans into a confrontation over how much affluent Americans should pay to help others cope with a struggling economy. . . .
>
> "It's interesting to note that independents, Democrats and Republicans and even the Tea Party agree it's time for millionaires and billionaires to pay **their fair share** of taxes," [Senate Majority Leader] Reid said Wednesday.
>
> (*The New York Times*, October 6, 2011)

But what is the fair share? How is it to be determined, and by whom? When Senator Reid says, "it's time for millionaires and billionaires to pay their fair share," he implies they haven't been doing so thus far. How does he know? What's the standard? If there's an objective standard for one's fair share, why does it only seem to be those from the left side of the political spectrum who say it's not being paid? And if there isn't an objective standard, how can the fair share be determined? **The truth is, fairness is almost entirely in the eye of the beholder, and "get them to pay their fair share" seems like just another way to say "raise their taxes."**

There's probably only one element of fairness that's beyond discussion: those with higher incomes should pay more in taxes. After that, everything is up for grabs.

- For example, we have a progressive system of taxation, meaning that higher earners don't merely pay more in terms of dollars; they generally pay a higher percentage of their incomes in taxes. Most people agree that this is fair. But is it? Why should success be penalized through greater taxation? And if the tax rate for those who earn more should be higher, how much higher? Should the top marginal tax rate be double that applicable to lower-income taxpayers? Triple? What's fair?

- Are some forms of income more desirable to society and thus deserving of taxation at lower rates?

- And should we encourage certain expenditures by making them deductible from taxable income?

The fairness of all of these things is subject to discussion and disagreement. They come under the heading of tax policy.

<u>Is Taxation Progressive? Progressive Enough?</u>

Under the U.S. system, people in higher income brackets pay tax at higher rates. (However, Mark Twain said, "All generalizations, including this one, are false." For an exception to the generalization above, see the discussion of the "Buffett Rule" on page 5.) **In large part, the question of fairness primarily surrounds whether the higher rates are high enough.**

Talk about "the eye of the beholder." There's evidence on both sides of this debate:

- The top 1% of U.S. taxpayers pay 38% of all individual federal taxes. The top 10% pay 70% of all taxes, the top 25% pay 86%, and the top 50% pay 97%.

- That leaves the bottom 50% of all taxpayers paying only 3% of the total.

- About half of Americans pay no federal income tax, and almost 25% pay no federal taxes at all.

- The average federal income tax rate for the top 1% of Americans is 23% (and for the top half it's 14%), while the average rate for the bottom half is 3%.

Notwithstanding the rhetoric, there's no doubt about the fact that America's top earners are taxed more heavily than the rest. On the other hand, they pay at lower rates than they used to (when I was a boy the top marginal rate was 94%), and it seems progressivity has declined.

> . . . the effective federal tax rate, including payroll taxes, for the wealthiest 0.01 percent of earners fell to 31.5 percent in 2005, from 42.9 percent in 1979 [for a decline of 26.6%], according to data from the Congressional Budget Office. Over the same time, effective rates for taxpayers in the center of the range fell to 14.2 percent, a decrease of just 4 percentage points [or 22.0%]. (*The New York Times*, September 21, 2011)

Total revenues from income taxes have declined in the U.S. – they "are at a historical low of 15.3 per cent of the gross domestic product, compared with a postwar average of 18.5 per cent" (*Financial Times*, September 25) – and they've declined more for top earners than for the rest. This is because of both specific rate cuts that have been enacted and the fact that the rates applied to dividends and capital gains – which clearly flow more to people in the upper income brackets – have declined relative to the rates on salaries and wages.

On average, higher earners absolutely do pay a higher percentage than those who earn less. But the decision as to whether the differential is just right, too little or too great is highly subjective and certainly a valid topic for debate.

<u>Righteous Income</u>

In the U.S., different types of income are taxed at different rates, suggesting some are considered more virtuous than others. For example, profits on investment assets held for more than a year, so-called "long-term capital gains," are taxed less than "ordinary income" such as salaries and interest. This has been the case for so long that we consider it the norm, and what we're used to often becomes the baseline for "fairness."

Long-term capital gains are taxed at reduced rates because of a judgment that long-term investment in things like securities, companies and real estate is beneficial for the economy and should be encouraged. Right now, the top tax rate on long-term investment profit is less than half that on short-term gains and ordinary income. And in recent years, the taxes on dividends have been reduced to similar levels, in part to mitigate double taxation of corporate profits but also because of a judgment that the equity investments that give rise to dividends are good for our society.

Is it appropriate to tax profits on long-term investments at rates below those on other forms of income? Certainly we should encourage investment, but there's no consensus that the tax code is the place to do it. Some foreign jurisdictions don't tax capital gains at all, while others tax them at the same rate as all other income.

What about interest? Why are dividends taxed at preferential rates and interest at ordinary rates? The explanation may lie in the fact that interest is deductible for corporations, while dividends aren't. Interest is paid out of pretax income, while in theory dividends are paid out of after-tax income – although the existence of corporate deductions and credits means dividends may, in fact, be paid out of income that hasn't been taxed by the U.S. Alternatively, the difference in tax treatment may be the result of a desire to encourage investment in "risky" equities rather than "safe" debt. But some companies' dividends are no doubt safer than some other companies' interest payments, so this distinction is questionable. If the goal is to encourage risk bearing, is dividend versus interest the right criterion?

While on the subject of gains from investments, it's interesting to note that, not long ago, dividends were included with interest under the rubric "unearned income." This pejorative phrase implied that income on capital, not requiring labor, was less virtuous than that stemming from labor, so-called "earned income." Thus unearned income – primarily dividends and interest – was taxed more heavily than wages.

But now things have turned 180 degrees, and returns on capital are taxed at lower rates than wages. It's worth noting that the Democrats – commonly considered the party of labor – controlled the government for much of the period 1928 to 1980, when earned income was favored. On the other hand, the Republicans – the party of those with capital to invest – have been in control more of the time since 1980, and the taxation of returns on capital has declined in relative terms. **The definition of virtuous income that should be encouraged through lower taxes clearly is subjective, impermanent and subject to change with the winds of politics.**

One debate that has arisen recently surrounds the so-called "Buffett Rule." For the last few years, Warren Buffett has been speaking about the fact that he pays a smaller percentage of his income in taxes than does his secretary. Presumably this is because his income consists primarily of long-term capital gains and very little of salary, bonus and interest.

(As an aside, it should be noted that Buffett's lower tax rate, while not unique, is far from the norm. According to *The New York Times* of September 24, "The number of people who fall under the Buffett Rule is quite small, only 60,000" out of 450,000 taxpayers who make over $1 million. "And the amount of revenue that would be generated [by the Buffett Rule] over the next 10 years is equally small – just $13 billion. . . .")

Buffett's tax status is a function of policy choices made by the people who wrote our tax laws. According to *The New York Times* of September 21, "President Obama's proposal for a new tax on millionaires . . . would counteract decades of tax reductions for most Americans that have given the wealthy the most benefit. . . ." Do we consider these decisions appropriate in principle and Buffett's just an extreme case? Or do we want to change things so returns on capital are less favored and big earners can never pay overall taxes at lower rates than those who earn less? (And, as an aside, are all long-term profits truly beneficial to society? How, for instance, does society benefit when someone buys a bar of gold?)

<u>Deductions, Loopholes and Tax Incentives</u>

Speaking of gold, in "All That Glitters" on that subject, I quoted from a speech by Mississippi state legislator "Soggy" Sweat that showed his ability to simultaneously praise and condemn whiskey with equal conviction. Outdoing Soggy, depending on who's talking, Washington politicos use the three very different terms above to describe the same thing: offsets to taxable income.

The drafters called them **deductions**: provisions that reduce the net income on which taxes are levied. Critics call them **loopholes**, suggesting there's something underhanded about those provisions. And politicians use the laudatory-sounding term **tax incentives** to describe tax code provisions that reduce tax revenues in order to encourage certain behavior. It all depends on your point of view.

Let's take a look at one of the most popular deductions: interest on mortgages. For as long as I can remember, interest on home mortgages has been treated as a desirable expenditure that should be encouraged. Because home ownership is considered part of the American dream, the tax code subsidizes it by reducing the after-tax cost for those who borrow to buy homes (and are able to itemize rather than take the standard deduction). While everything else may be arguable, certainly this seems fair. But is it?

- Are homeowners more virtuous than renters? If mortgage interest is deductible but rent isn't, we're requiring renters to subsidize owners. Is that appropriate?

- On average, homeowners are from the middle and upper income brackets. Is it fair that poorer renters provide a benefit for richer owners?

- And is it desirable that those able to buy more expensive homes should get more of a subsidy than those consigned to cheaper ones?

As with the taxation of dividends, judgments on these matters change over time. Until 1987, there was no limit on the amount of mortgage interest that could be deducted. If you could afford to own ten homes with multiple million-dollar mortgages on each one, taxpayers would collectively share the cost by reducing your income taxes due. Today interest is deductible on only a maximum of $1.1 million of debt, and only on first and second mortgages, and only on a primary residence and a second home. So the tax treatment of owners of many homes and more expensive homes has become less generous. But it's still better than that of renters. Is that proper?

What about the tax deductibility of charitable donations? As I travel the world visiting with clients, I see that two things about the U.S. are quite uncommon: (a) Americans give a lot of money to charity and (b) donations to charity are deductible in calculating taxable income. Everyone tells me the latter is the main reason for the former. In particular, these things are part of the explanation for the existence of the many private, non-state-supported colleges and universities in the U.S., the best of which are so good at least in part because of their significant donor-provided endowments. For example, Harvard and Yale are only half as old as England's Oxford and Cambridge, but they benefit from endowments that are far larger.

Part of this is true because legislators decided at some point to subsidize non-profits by encouraging contributions through the tax code. That's certainly understandable. And yet, changes were made in recent years to limit upper-bracket taxpayers' use of deductions in order to ensure that they pay some minimum tax rate.

What about the unevenness of the subsidy? The cost of giving $1 to charity is reduced by the amount of taxes it saves the donor, which is equal to $1 times the person's tax rate. So today, speaking simplistically, it costs a top-bracket taxpayer 65 cents to give a dollar to charity, while it costs a bottom-bracket taxpayer 85 cents. Is that fair? Should the bigger earner receive a greater reward for a dollar of philanthropy than someone who can afford it less easily? And should those who aren't inclined to give to charity be required to subsidize those who are?

Finally, what about state and local taxes, the third of the significant deductions? Here tax deductibility isn't due to a decision to encourage people to pay non-federal taxes, but rather to cushion the effect of being taxed in multiple jurisdictions. Texas, Florida and five other states have no personal income tax, California has a heavy one, and someone living in Manhattan pays tax to both New York State and New York City. Deductibility on the federal tax return somewhat evens out the burden and ensures that (a) the states get first crack at taxing income and (b) the federal government can only tax what's left, in line with federalist principles.

This raises a number of questions. Is the deductibility of state and local taxes fair? As with other deductions, the key question is "fair to whom?" Some people pay more state and local taxes than others, meaning they get greater deductions than others. As a result, while a person with a given income who lives in a high-tax state pays higher total taxes, he or she pays less federal tax than someone in a low-tax state. Is that fair?

Further, what all of this means is that by providing more benefits to its residents (or at least spending more money, whether beneficially or not), a high-tax state creates a deduction for its residents and thus reduces the federal government's total tax take. Is this right? Should the federal government subsidize spending on the part of high-tax states? That is, should residents in low-tax states bear part of the expenses of high-tax states? There's nothing simple about these matters.

While the source of an exemption rather than a deduction, what about interest on "municipal bonds" issued by states, counties, cities and local agencies. This is exempt from federal taxation, under the legal doctrine that the federal government mustn't tax the operations of the states. ("The power to tax is the power to destroy," one of our great Supreme Court decisions held.) But here again, we're talking about a federal benefit (in the form of a lower cost of capital) for the biggest-spending local governments and their citizens, and a tax break for people who lend to them.

And what about property taxes? These are deductible without limitation. Thus the owner of a mansion – or ten mansions – receives more of a tax benefit than a low-income earner. And it's another subsidy for homeowners versus renters. Is this right, or should it be changed?

To date, it has been deemed fair for state and local income tax to be deductible on federal tax returns. But is this immutable? Sales tax used to be deductible, too (meaning the buyer of a Rolls Royce got assistance from the federal government). Now it's not. More fair?

What if the deduction for state and local taxes and the exemption for muni interest were ended? This would increase the cost of financing for state and local governments and most impact the highest-spending states, potentially requiring higher taxes causing people to move away. This would reduce those states' revenues and require them to raise taxes further (and drive away still more taxpayers) in a painful cycle. And are those states profligate or just burdened (like California by a substantial low-income population) or natural-resource-poor (lacking Texas's oil)?

So even in "small" matters like the tax deductibility of mortgage interest, charitable donations, and state and local taxes, there are lots of difficult questions. While on their face the deductions seem fair to homeowners, philanthropists and residents of high-tax states, they're simultaneously penalizing renters, non-donors and residents of low-tax states (as well as taxpayers in low tax brackets and those without enough deductions to itemize).

How about the biggest exclusions of all: employer-provided health care and the deferral of taxation of contributions to pension plans? In both cases, those receiving these employer-paid benefits enjoy a substantial benefit not shared by those not fortunate enough to participate. For instance, is it fair that many better-paid workers get thousands of dollars a year in untaxed health-care benefits, while other workers enjoy no such subsidy?

Fairness turns out to be quite an elusive concept.

<u>Reasons for Increasing Taxes</u>

As U.S. leaders wrestle to reduce the budget deficit in the coming months and years, spending cuts are a certainty. But the question of whether taxes should be increased is sure to be hotly debated. A number of justifications for doing so are advanced:

- Some people want wealth to be redistributed throughout society by taxing the rich and giving to the poor. They want the government to do more for those who are less fortunate (or less able), and that means having the rest pay for it.

- There's an argument that for the deficit solution to be equitable, all citizens should contribute to it. Though some government spending benefits all citizens alike, such as national defense, national parks and the administration of justice, much spending disproportionately benefits lower earners, in the form of public education and transportation (which are supported by the federal government), unemployment insurance, food stamps, Medicare and Medicaid, etc. Thus the effect of the coming spending cuts will fall more heavily on the poor. Some argue that since they receive less in benefits and are therefore less likely to experience their loss, the wealthy should share the burden of reducing the deficit through increased tax payments.

- As opposed to the ideological arguments reviewed above, tax increases are among the limited number of possible contributors to deficit reduction listed on page 1. Thus, in the simplest terms, we can cut more from the deficit if we tax more (all else being equal).

- The ultimate practical point is that spending cuts alone won't do much to eliminate the deficit.

- Viewed another way, promises of entitlements have been in place for decades, people have relied on them, and those promises have to be kept. This is clearly impossible without increased taxes and/or exploding deficits.

Is redistribution a valid goal? To some people, it is part of the process of helping every citizen in the "pursuit of happiness." To others, it's akin to socialism and contrary to the American ethic in which rewards follow ability and hard work.

Should everyone contribute to deficit reduction, including bigger earners through the biggest tax increases? Or should the savings come primarily through sacrifices

on the part of those who to date have been the primary beneficiaries of excessive government spending? I have no doubt that we'll see fireworks on these topics.

Reasons for Not Increasing Taxes (or for Lowering Them)

Before concluding that the above points are persuasive, you should consider the equally numerous arguments to the contrary.

- Many believe our massive deficit stems from a government (and an entrenched army of government employees) willing and able to spend all available cash (and more). A bureaucracy will always find uses – many of them wasteful – for available revenues. Thus the only solution is to "starve the beast": only tax cuts and restraints on borrowing will force the government to limit spending.

- It is argued that by decreasing the after-tax proceeds from a dollar earned, tax increases reduce people's incentive to work, and thus cut into a nation's overall productivity. From 1974 to 1979, Britain's top marginal rate was 83% (although with a 15% surcharge on interest and dividends, it could rise to 98%). I remember reading about a banker who took time off without pay to paint his house. Society benefits when each of us does the things we're best at. But if a banker who earns $20,000 a month only gets to keep $3,400, he's better off forgoing a month's salary to avoid paying a painter who gets $5,000 a month.

  Research into the "elasticity of taxable income" (ETI) shows that "when marginal tax rates go up, the amount of reported incomes goes down," suggesting higher taxes do reduce productivity. (*The Wall Street Journal*, March 30, 2010). Of course, it's also possible that when rates go up, the incentives for failing to report income also go up. Thus part of the ETI effect could come from under-reporting, as opposed to reduced effort.

- Taking the above a step further, the "Laffer curve," named after economist and presidential adviser Arthur Laffer, posits that by discouraging work (and thus reducing incomes), raising income tax rates actually reduces income tax collections. Thus, by increasing taxable income, rate reductions bring revenue gains.

- Last but especially timely is the classic Keynesian argument that raising taxes and thus reducing after-tax incomes shouldn't be done at a time when the economy is weak and spending should be encouraged, not inhibited.

For me the bottom line – the real reason why many people don't want rates to go up – is that they don't want to pay more taxes. I think people tend to "vote their pocketbooks," meaning many people with incomes to tax will vote for the candidate who promises lower taxes. **But the economic theories discussed above certainly lend validity and**

even nobility to the pursuit of higher after-tax income . . . and the fact that their supporters are self-interested doesn't make them wrong. Finally, for whichever reason, a good portion of the electorate buys these arguments. And *The New York Times* reported on November 2 that "Americans for Tax Reform, a taxpayer advocacy group . . . says that 41 senators and more than 235 House members have pledged in writing to oppose all tax increases."

<u>Topics in the News – Income Inequality</u>

One of the outstanding characteristics of the U.S. economy at this time is the rising dispersion between incomes. The percentage of total income going to higher earners has been increasing dramatically, whether because of (a) the rising importance of education and technological literacy or (b) the movement of work offshore, the declining availability of blue-collar jobs and the reduced power of private-sector unions to garner wage gains. And given the pattern of tax cuts and the special treatment given to income on capital, the tax system has magnified the divergence.

A recent report from the Congressional Budget Office provided dramatic evidence of the divergent trends in income. It outlined the percentage gain in average inflation-adjusted after-tax income of various income groups between 1979 and 2007:

• Top 1% of the population in terms of income	275%
• Next 19%	65
• Middle 60%	40
• Bottom 20%	18

According to the CBO:

> The share of income going to higher-income households rose, while the share going to lower-income households fell.
>
> - The top fifth of the population saw a 10-percentage-point increase in their share of after-tax income.
> - Most of that growth went to the top 1 percent of the population.
> - All other [quintile] groups saw their shares decline by 2 to 3 percentage points.

An October 26 article in *The New York Times* reported the following conclusions:

> . . . the report said government policy has become less redistributive since the late 1970s, doing less to reduce the concentration of income.

> "The equalizing effect of federal taxes was smaller" in 2007 than in 1979, as "the composition of federal revenues shifted away from progressive income taxes to less-progressive payroll taxes," the budget office said.
>
> Also, it said, federal benefit payments are doing less to even out the distribution of income, as a growing share of benefits, like Social Security, goes to older Americans, regardless of their income. . . .
>
> Also cited as factors contributing to the rapid growth of income at the top [in addition to federal tax and spending policies] were the structure of executive compensation; high salaries for some "superstars" in sports and the arts; the increasing size of the financial services industry; and the growing role of capital gains, which go disproportionately to higher-income households.

The implications for tax discussions are obvious. Upper earners have moved further ahead relative to lower earners, and tax policies have contributed to this trend. **For those who think progressivity should be bolstered, income should be redistributed, and those most able to pay should contribute more heavily to solving the deficit problem, upper-bracket earners make a most attractive target.**

<u>Topics in the News – The Sputtering Economy</u>

In early 2011, there was a growing consensus that the U.S. economy was on an upward trajectory – that recovery had taken hold. Reported growth in GDP was accelerating. Orders, sales and profits were strong. Cash was piling up in corporate coffers. The Fed gave increased thought to increasing interest rates to cool off the economy and prevent the rekindling of inflation.

But in the summer it was reported that the economy had cooled, and earlier estimates of GDP were revised downward. A possible double-dip recession became the topic of the day. At the same time, an unseemly political confrontation regarding the U.S. federal debt ceiling exposed a flawed, unconstructive political system at work; produced a downgrade of long-term Treasury debt on the part of Standard & Poor's; seemed to take us to the brink of a default; and sapped confidence at all levels.

Despite the economy's weakness, further government aid for the economy has been rendered untenable by widespread negative feelings about the stimulus programs of 2007-08 and the popular view that the government took care of Wall Street but not Main Street, combined with the nearness of the next presidential election. **Especially with stimulus unlikely, government actions that discourage growth should be viewed skeptically.**

In the U.S. – just like in Greece and elsewhere in Europe – the answer to problems of excessive deficit and debt can be summed up in one word: austerity. Everyone's after debtor nations to practice austerity; that is, to spend less and tax more. The problem is that such behavior will reduce citizens' incomes, discourage consumer spending and slow or reverse economic growth. While on paper austerity will cut deficits, it may actually add to them by reducing government tax collections. In this way, it would necessitate further borrowing.

There's no doubt that, along with spending cuts, tax increases would have a detrimental impact on the prospects for economic recovery. Thus even people who are open to tax increases may not want them to be effective until the economy is out of danger. As the *Financial Times* put it on October 29, "Many households are so badly overleveraged that a balanced federal budget would ruin them."

But our economic problems aren't just cyclical. There are worrisome secular trends, many surrounding the scarcity of new jobs, the movement of manufacturing overseas, and the low level of business investment in the U.S. **The best cure for our cyclical and secular difficulties would be growth based on industrial expansion.** This would put people to work, support increases in spending, reinvigorate the housing sector, increase tax revenues and shrink the deficit. **But for this to happen, we need (a) tax rates that allow successful entrepreneurs to retain a substantial percentage of the resulting profits and (b) confidence that the tax system won't be made more confiscatory after they've made their investments. At the present time, the latter, in particular, is very much lacking.**

<u>Topics in the News – Flat Tax</u>

It's interesting to note that writers of tax law have two main routes to a given revenue total: low rates without deductions, exemptions and credits, or high rates with them. To date they have chosen the latter course. An article in *The Wall Street Journal* of January 29, 2011 marked down this choice to pure politics:

> Why did [Roosevelt's high tax rates] last so long . . . beginning their long steady decline only during the Kennedy administration? . . . In part to fund the Korean conflict and the Cold War, but also to grease the skids of modern politics. Lawmakers were able to blunt the effect of high statutory rates by handing out tax preferences to their friends, constituents and contributors. Steep rates preserved the appearance of progressivity (and, to be fair, some of the reality), while supplying politicians with their stock in trade: favors.

There are periodic calls for lower "flat" income tax rates and the elimination of deductions and other wrinkles, and we are hearing them today. The main goal is tax simplification. I commend this. (I have to admit that I, with my MBA in accounting, stopped being able to understand my own tax return decades ago.) **But of course we**

cannot convert to a flat tax system without altering people's relative taxes. A change would require sweeping policy decisions.

Flat tax proposals are often accompanied by calls for a national sales, consumption or "value added" tax on spending, such as many other nations have. The problem here is that those with low incomes spend most or all of their earnings on life's necessities, and as incomes rise, people gain the possibility of spending less of their incomes and saving more. Thus sales taxes tend to take a higher percentage of income the lower one's income. That's why, in contrast with progressivity, sales taxes are described as "regressive."

Last month, Republican presidential candidate Herman Cain announced his "9-9-9 plan," which features a flat 9% income tax rate, 9% national sales tax and 9% business tax. Let's take a look at it. The Tax Policy Center is a non-partisan joint venture of the Urban Institute and Brookings Institution. The *St. Petersburg Times'*s politifact.com summarized the results of the TPC's analysis as follows: "83.8 percent of tax filers would get a tax increase . . . compared with current tax policy. On the other hand, most of the tax filers who make more than $1 million would get a tax cut . . . about 95.4 percent of this high income group."

Would it be right to make poor people pay income tax at the same rate as rich people <u>and</u> pay a higher percentage of their incomes in a national sales tax? Anything's fair game, I guess, but if the TPC's analysis is correct, this plan would represent a step away from progressivity and further skew after-tax income toward the wealthy. Yet we're likely to hear a lot more about flat tax during the coming campaign. **When confronted with complex problems, people often welcome simple solutions.**

<u>Topics in the News – Political Posturing</u>

A Democratic politician I know decided not to run for president in 2008 because he expected a rising tide of populist rhetoric to be required. He was right: classist speech rose substantially. And the rise continues unabated.

Democrats tend to lean toward bigger entitlement programs, greater governmental involvement in the economy, deficit spending, progressive taxation and income redistribution. These things are in contrast to Republicans' averred traditions of small government, individual self-sufficiency, free markets, balanced budgets and tax reduction. At the present time, with the economy performing poorly, Democrats are glad to describe Republicans' *laissez faire* policies as having contributed to joblessness and economic hardship. With difficulty more prevalent than prosperity today, populism – appealing to disadvantaged economic classes based on claimed inequities – represents a compelling brand of politics.

Thus in recent months we've increasingly heard Democratic politicians sneer at "millionaires and billionaires" (see Senator Reid on page 2), an epithet aimed at a group that's supposedly been getting away with something. (In the past, I seem to recall, it was instead a group most people wanted to be part of.) To date, the preferred Republican label for people with money has been "job creators," although this line of defense may be tough to maintain in the current climate.

The *Financial Times* of October 29 carried an article headlined "Obama takes high-risk stance against the rich." It described a decision to emulate Roosevelt's Depression-era rhetoric and point an accusing finger at the Republicans as the party of wealth.

> Throwing out the standard presidential playbook dictating an aspirational approach to centrist voters, the White House is cementing a message that strikes at wealth and privilege.
>
> "There is surging sentiment among voters that the economy is weighted towards the wealthy," said a senior White House official.
>
> The White House strategy will make the 2012 election a generational test of the Republican push of the last three decades for cutting taxes, in ways their critics say have been constantly skewed towards the highest earners.

However, the article goes on to say Republicans may respond in kind to this tactic, joining in support of the common man rather than standing up for wealthier supporters:

> . . . Republicans are tweaking their public message, with the hardline [H]ouse majority leader, Eric Cantor, recently acknowledging the need to address the rich-poor gap.
>
> Mitt Romney, the frontrunner in the race to challenge Barack Obama in 2012, has taken to saying that he is standing up for the "middle class" because the rich "can look after themselves."

With candidates in both parties competing to sound less pro-wealth, top earners and their supportive tax policies should expect to be rhetorical targets in the coming election. Whether this will extend to Republican candidates dropping their resistance to tax increases remains to be seen.

<u>The Ultimate Worry: Tyranny of the Majority</u>

The elements that contributed importantly to America's success included economic aspiration, upward mobility and a tax system that encouraged labor and risk-taking. In short, we all could get rich. **As a result, both those with money and those hoping to make money were attracted to the idea of low taxes. This made tax reduction a very popular theme over the last few decades.**

But when people without money start to believe they can't make money, there's little to keep them from taking it from those who have it. This represents a threat to our way of life.

As I've written before, I was very impressed when, as a young man, I heard an interesting explanation for America's economic progress relative to Great Britain: "When the worker in Britain sees the boss drive out of the factory in his Rolls Royce, he says 'I'd like to put a bomb under that car.' When the worker in America sees the boss drive out of the factory in his Cadillac, he says 'I'd like to have a car like that someday.' " This tale says a lot about how we achieved our success . . . and also about what we'd better retain if we want to keep it.

The truth is, in a democracy, the lower-earning majority is perfectly capable of voting to confiscate the wealth of the minority. A lot of people have written about this and associated threats to our system:

> "If Sparta and Rome perished," asked Rousseau in his Social Contract, "how can any state hope to live forever? The Body Politick, like the body of a man, begins to die as soon as it is born; it contains the seeds of its own destruction. (*Financial Times*, October 29)
>
> "When men get in the habit of helping themselves to the property of others," warned the New York Times in 1909, "they are not easily cured of it." (*The Wall Street Journal*, January 29, 2011)
>
> Some people regard private enterprise as a predatory tiger to be shot. Others look on it as a cow they can milk. Not enough people see it as a healthy horse, pulling a sturdy wagon. (Winston Churchill)
>
> As Margaret Thatcher famously said, the problem with socialism is that sooner or later "you run out of other people's money." (*New York Post*, January 12, 2011)

The risk is exacerbated today by the fact (as noted earlier) that about half of all Americans pay no federal income tax. This makes me wonder whether our democracy can make good decisions about taxation when half the people are outside the system.

Obviously, it's tempting to many to increase taxes on the rich, seeing it as a harmless way to enhance the welfare of the many at a small cost to the few. But the damage to the U.S.'s success machinery could vastly outweigh the sums confiscated from those who are targeted. **The "fair share" taken from upper bracket earners has to be kept as small as possible if the tax system is to benefit all of our society. The coming debate over tax increases will be very important in this regard.**

There can be no easy solution. Social programs and tax policies have been put in place that will combine with demographic and income trends to create challenging conditions. "The Middle-Class Tax Trap" (*The New York Times*, April 17, 2011) outlined the consequences:

> [Consider] the "current law baseline," a Congressional Budget Office projection in which the Bush-era tax rates aren't renewed in 2012, the Alternative Minimum Tax (which is supposed to hit only the rich but increasingly bites into middle-class paychecks) isn't indexed for inflation, and Medicare payments to doctors are slashed 20%.
>
> With these changes, the deficit drops away in the next 10 years, and more important, it stays manageably low for the decades after that. . . .
>
> This is how the "current law baseline" cuts the deficit: Thanks to inflation and bracket creep, its tax code generally subjects more and more Americans to rates that now fall only on the wealthy.
>
> Today, for instance, a family of four making the median income . . . pays 15% in federal taxes. By 2035, under the C.B.O. projection, payroll and income taxes would claim 25% of that family's income. The marginal tax rate on labor would rise from 29% to 38%. Federal tax revenue, which has averaged 18% of G.D.P. since World War II, would hit 23% by the 2030s and climb ever higher after that.
>
> **Such unprecedented levels of taxation would throw up hurdles to entrepreneurship, family formation and upward mobility. . . .**
>
> They could have ugly political consequences as well. Historically, the most successful welfare states (think Scandinavia) have depended on ethnic solidarity to sustain their tax-and-transfer programs. But the working-age America of the future will be far more diverse than the retired cohort it's laboring to support. Asking a population that's increasingly brown and beige to accept punishing tax rates while white seniors receive roughly $3 in benefits for every dollar they paid in (the projected ratio in the 2030s) promises to polarize the country along racial as well as generational lines.
>
> **The Republican vision for entitlement reform, President Obama said last week, would lead to a "fundamentally different America" than the one we inhabit today. He's right: asking the elderly to pay more for their health care, as [Representative] Paul Ryan proposes to do, would transform the American social contract, and cause no small amount of pain.**

> **But what Obama doesn't acknowledge is that the alternative path could lead to a different country as well – a more stagnant and balkanized society, in which our promise to the elderly crowds out the fundamental promise of America itself.** (Emphasis added)

Will we keep the promise of entitlement programs or cut them back? Given the prominence of entitlements in the U.S. budget, in large part it comes down to that.

Over the last 80 years, politicians in the U.S. created entitlement programs that we cannot afford. Likewise, to varying degrees citizens throughout the developed world have been given promises their governments can't keep. That a day of reckoning would arrive is not news – credible observers have warned of our current problems for decades – but few politicians have been willing to fall on the sword of unpopular solutions.

Whatever action is taken now, it will not be pain-free. The unpayable debts run up in the past will have to be dealt with. And as for the future, there are only three possibilities: the promises will have to be scaled back, the tax burden will have to grow, and/or the deficits will have to be permitted to increase. If nations are to limit deficits – and it seems they may be forced to – there is no alternative to the first two of these. This fundamental truth will constitute a major portion of the public debate in coming years.

Tax policy consists of deciding who to take from (and how much) and who to give it to. There are no easy answers. We should all throw our support behind the common good and not just our individual interests.