

Progressive Taxation, Class Warfare, and the Lucky 400

On January 30, the US Internal Revenue Service reported that the richest 400 Americans paid an average of 17.2% in federal taxes in 2006, including social security and medicare taxes, of which they paid virtually nothing. Not only are the wealthy keeping most of their money, but they have more to keep: these Lucky 400 earned 1.3% of all US personal income in 2006, up from just 0.5% as recently as 1992. Alone among major developed democracies, the US has a tax system that is, at least at its upper reaches, regressive.

In what was widely considered a serious gaffe, then-candidate and now Vice President Joseph Biden said during the campaign that for America's rich, "it's time to be patriotic" by "stepping up to the plate" and paying more in taxes. He was vilified -- and the incoming administration of Barack Obama has been vilified since -- for fomenting "class warfare." The experience of the Lucky 400, however, raises the question of who's fighting whom? If we really are in the middle of a class war, clearly it is the rich who are winning.

Of course, no one wants to pay taxes. Everyone agrees that tax burdens should be fairly distributed across populations. But fairness is a slippery concept. Most developed democracies employ a progressive income tax to fund the bulk of government operations. The tax rate goes up as income goes up.

Income taxes in the US, on the other hand, are notoriously un-progressive. In the US, the first US \$8000 of wage income is taxed at 17.65%, while income over US \$358,000 is taxed at just 35%, a difference to be sure but much less a difference than in Europe, Japan, or Australia. Typical middle-income Americans pay a marginal tax rate of 32.64% on wages, nearly as much as the movie stars and corporate CEOs who fall in the top bracket. Moreover, capital gains taxes on investment income max out at a mere 15%. This low capital gains rate (paralleled only in the UK) is the reason why the Lucky 400 pay such low taxes on average.

As a result, Warren Buffet, Bill Gates, and most hedge fund and private equity managers actually pay less (as a percentage of income) in taxes than do minimum wage workers. By any definition of fairness, this seems unfair. Warren Buffet himself has repeatedly said so. It's impossible to arrive at an objective standard of fairness. It is possible, however, to examine how standards of fairness have changed over time. An interesting comparison is to look back to the America of 50 years ago. No one would characterize the 1950s as a period of "class warfare."

In 1958, Eisenhower was in the White House, cars had tail fins, and the Dodgers and the Giants followed America west to the coast. The era of civil rights reform had begun and Vietnam was only a cloud on the distant horizon. And rich Americans paid 91% of their marginal income in taxes.

Now that's what I call patriotism! Yes, most income over US \$200,000 was taxed at a marginal rate of 91%. Ordinary Americans didn't pay this rate: US \$200,000 in 1958 was equivalent to over US \$1.5 million today. Ordinary Americans paid around 30% at the margin, similar to what they pay today. But they paid much less in total taxes, because the first US \$2000 (about \$15,000 today) was taxed at just 4%.

Over the past fifty years, wage taxes on the rich have declined from 91% to 35%, wage taxes on the middle class have risen slightly, and wage taxes on the very poor have risen from

around 5% to around 20%. If the tax burden was more or less fairly distributed in 1958, then it is certainly not fairly distributed today. Of course, the reverse is also true. If the tax burden is fairly distributed in America today, 1958 America was, by implication, some kind of social democratic paradise.

The question Americans must ask themselves is: which society would they rather live in, 1958 America or 2008 America? In 1958 America, working class jobs paid decent wages, homeownership was expanding rapidly, and ordinary people could afford to send their children to college. In 2008 America, working class families can't make ends meet, home foreclosures are at an all-time high, and kids have to work full-time to help pay their own tuition. Tax policy is a big part of the difference.

The question Europeans and other must ask themselves is: which society would they rather live in, their own or America's? Increasingly, elite opinion around the world is endorsing a US-style social model. The current crisis has caused no more than a pause in this trend. Nowhere has the shift in favor of the wealthy been as extreme as in the US, but the shift has occurred everywhere. No major developed democracy taxes the wealthy at anywhere near the rates that were typical in the 1950s.

The Lucky 400 Americans (and their European and worldwide counterparts) have taken massive losses in the current economic crisis. They are successfully lobbying governments around the world to bail them out of their investment mistakes. None of the major global stimulus packages has focused on support for the poor and working classes. Neither Barack Obama nor any other democratically-elected leader is offering a return to 1958 standards of fairness. The American electorate and the electorates of every democracy in the world deserve to know why.