Talking Points: Tilting the Tax System in Favor of the Rich

The progressive tax system, which was set up to ensure that rich people shoulder a bigger share of the government's bills than the not-so-rich, is in trouble.

Wealthy individuals and large corporations have been steadily, and successfully, prevailing upon their congressional allies to rewrite the tax code, shifting more of the burden onto others.

Among their recent victories:
• Shrinking the estate tax
• Rolling back taxes paid by investors and corporations
• Using revenues from payroll taxes on workers to mask the cost of tax cuts for the rich

Congress came back from its summer recess this year planning to hand America's wealthiest families their biggest tax victory in years: permanent repeal of the estate tax.

Hurricane Katrina interfered with those plans. Even die-hard tax slashers realized that after a national - televised - tragedy in which thousands of poor people were unable to get out of harm's way, the timing was not right for a multi-billion-dollar tax cut on America's largest fortunes. But when the memories of Katrina fade, opponents of the estate tax will no doubt try again to get rid of it.

Opponents of the estate tax use inflammatory sound bites like "death tax" or "double tax" to make it look like they are concerned about eliminating injustices. But their real aim is to take another giant step in the direction of abolishing taxes on investments - especially capital gains on stocks, bonds and real estate. Because investors are disproportionately wealthy, repealing or reducing investment taxes produces a windfall for those at top. That further erodes the tax system's progressivity - the principle that one's share of the tax burden should rise with one's ability to pay.

In addition to being unfair, estate tax repeal is unaffordable. The first 10 years of repeal would cost the Treasury $745 billion, and nearly $1 trillion when interest is factored in, according to Congress's Joint Committee on Taxation. That's far more than the entire projected budget for homeland security. The advocates of repeal don't talk about how this enormous decline in government revenue would be made up.

But since the federal government was already deeply in debt before Katrina - and paying to rebuild will only add to the red ink - the cost of estate tax repeal would eventually have to be covered by cutting government programs, raising other taxes, or some combination of the two.

It is not only the poor who lose out. The have-nots will pay for high-end tax cuts mainly through reduced government services. But the broad middle class will pay for them both in the form of higher future taxes and reduced government programs.

Against this backdrop, Katrina's interruption of the drive to repeal the estate tax presents an opportunity. Advocates for middle-class and poor Americans now have a chance to expose what is truly at stake at a time when Americans just saw up close what limited government, and the growing chasm between rich and poor, can mean.

Katrina was a moment of clarity for much of the country. This should extend to the tax code. What should be repealed is not the estate tax, but years of tax policies that have shielded too much of wealthy people's money from taxes, and shifted too much of the burden onto everyone else.

The Zeal for Repeal: The Drive to Do Away with the Estate Tax

Until Katrina struck, estate tax repeal was going to be one of the first items Congress took up when it returned from recess. Given the many pressing issues facing the nation - from chemical plant security to fixing the immigration system - it is clear that the people pushing repeal onto the national agenda have a tremendous amount of clout.
Who are they? The Bush administration, Republican members of Congress, and - not surprisingly - some of America's wealthiest families. Among them: the Morses of Mars candy bars, the Waltons of Wal-Mart, the Gallos of Gallo wine and the Tysons of chicken fame. These enormously wealthy families, who would stand to gain the most if the estate tax is eliminated, have largely stayed in the background.

Opponents of the estate tax have argued that it is a burden on large numbers of ordinary Americans - which it is not. And they have made their case by drumming away at a few sound bites - notably that the estate tax is a "death tax," or a "double tax." They have done an impressive job of staying on message, but their arguments are flimsy to the point of being fraudulent.

Calling the estate tax a "death tax" implies that the tax, like death, applies to everyone. It doesn't. "The death tax label added moral momentum to the case for repeal, turning the taxman into a pimp for the grim reaper," write Michael J. Graetz and Ian Shapiro in their book "Death by a Thousand Cuts: The Fight Over Taxing Inherited Wealth." This year, the tax applies only to estates valued at more than $1.5 million ($3 million for married couples), about the top two percent of estates annually. By 2009, only estates worth more than $3.5 million will face the tax ($7 million for couples) - less than one half of one percent of Americans.

Repeal advocates like to argue that the estate tax will hit farms and small businesses hard. Congress's own budget agency is the latest in a long line of researchers to debunk those claims.

The important point about the estate tax is that it is primarily the tax system's way of taxing wealth that has never been taxed. When people die, they generally leave behind assets like stocks, bond and real estate that have increased in value since they were purchased. In general, that appreciation is taxed when an asset is sold. But if these assets still belong to a person at the time of his or her death, there should still be a way to tax the value of the appreciation. The estate tax captures some of that untaxed profit.

The estate tax is clearly not an act of governmental viciousness. Nor is it moribud way to feast off the deceased. It is just the opposite - a big favor, or "death subsidy," in the form of lifelong tax deferral on profits as they compound over time.

The claims that the estate tax is a "double tax" are also misleading. There are a wide array of taxes that could be considered "double," depending on when you start counting. A worker's wages may be taxed by both the federal and state governments. Or the same worker may pay income tax on a dollar of income, and then a sales tax when the same money is spent. Unlike the investor sitting on an appreciated stock or bond, the worker doesn't get to postpone paying those taxes until after he or she has died.

The estate tax is primarily the government's way of ensuring that the wealthiest Americans ultimately - that is, after they die - pay their fair share. The real advocates of unfairness in this debate are the supporters of repeal, who want the rich to be exempted from tax on their appreciated assets. The people who would benefit from repeal, of course, would be those inheriting assets. Where there are winners, however, there are also losers.

The estate tax is still the government's most progressive tax. In 2004, for instance, the top 1 percent of households paid 23 percent of all federal taxes but 83 percent of estate taxes. If the estate tax were repealed, leaving heirs with bigger untaxed fortunes, the tax burden would shift to the less wealthy. Or else the shortfall in tax revenue would lead to cuts in government programs, which also would hurt the less well-off.

All this explains the zeal behind the repeal movement. Opponents of the estate tax know that they are waging an ideological battle - a battle against progressive taxation.

**The Untaxing of Investments: The War on Capital Gains Taxes**

The people who stand to gain from estate tax repeal are by and large the same people who benefit most from the ongoing campaign to cut or eliminate capital gains taxes - another tax that falls most heavily on the rich.

Hurricane Katrina prompted Congress to delay its plan to extend special tax breaks for capital gains, just as it did plans for repealing the estate tax. With the nation's attention focused on the poor storm victims of New Orleans, it would have been a problematic time to push through a capital gains tax whose benefits would go overwhelmingly to people who make more than $200,000 - about the top 3 percent of the income scale, while adding some $23 billion a year to the deficit.

The delay, however, does not mean that the cause has been abandoned. Ending the tax on investments, particularly capital gains, will no doubt remain a cherished goal of anti-tax conservatives.

In a nutshell, the argument against taxing investment gains is that doing so reduces the incentive for saving and investment, which in turn reduces job creation and wages. According to this theory, a tax on the wealthy ends up hurting everyone. In effect, these critics of the capital gains tax are saying that the main aim of the tax system should be economic growth, even if pursuing it means making the tax system more regressive. Economic growth, so the logic goes, will boost overall tax revenues, more than making up for the drag of regressive taxes.

The problem with this variation on the trickle down theory is that after centuries of debate and research, there is still no consensus on the relationship between capital gains tax cuts, investment, and economic growth. The growth that does occur when investment taxes are low generally flows to wealthy investors. And despite all the
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claims to the contrary, tax cuts have never been proven to pay for themselves.

This impasse leads to a fairness argument: Since the evidence is inconclusive that capital gains taxes have much of a negative effect, it seems unfair to largely exempt capital gains from tax while taxing wages and salaries. Perhaps more important, if the aim of the system is to distribute the tax burden based on ability to pay, capital gains must be taxed - even if doing so has a negative impact on saving and investment. In a progressive system, maintaining a degree of fairness is one of the core principles.

Opponents of capital gains taxes have already been remarkably successful. Through a combination of exempting some gains from taxation and reducing the rates, they have managed to whistle away at the taxes investors end up paying. Since the last big tax-code overhaul in the Reagan era, the tax rate on capital gains has dropped from a high of 28 percent in 1987 to just 15 percent in 2003. The 15 percent rate is ostensibly temporary, though Mr. Bush and his Congressional allies are fighting to make it permanent. By comparison, the top rate on income from employment is currently 35 percent.

The estate tax is another prime example. In 1980, the per-person amount of wealth exempt from the estate tax was $175,000. By 2009, the exemption is scheduled to rise to $3.5 million. And, of course, if the pro-repeaters have their way, estates will never face taxation.

Then there is the problem with the alternative minimum tax, which was designed to ensure that wealthy taxpayers pay their fair share. The alternative tax was first enacted in 1969, when it was learned that many multimillionaires used tax shelters to avoid paying any income tax. For years, many investors had to pay the A.M.T. when the tax rate for capital gains was lower than the rate on income from working. Since 1990, however, taxpayers who use the special low rates on capital gains have generally not had to pay the A.M.T. That change alone now saves investors billions of dollars in taxes each year.

Rather than fix the A.M.T., some members of Congress have recently proposed abolishing it. That would be yet another blow to fairness.

**Tax Avoidance Goes Global: Overseas Tax Shelters**

Another way the tax burden on the wealthy has been reduced is the decline in taxes on corporations.

Corporate incomes tax payments are made with money that would otherwise be paid to the companies' stockholders and bondholders. So the growing number of "opportunities" for corporations to avoid taxes - with the sometimes tacit, sometimes explicit, approval of Congress - are actually opportunities for investors to save on taxes.

In the last 50 years, the corporate income tax has virtually disappeared. In 1954, corporate income taxes provided 30 percent of federal tax revenue, a share equal to 5.6 percent of the size of the economy. It's been mostly downhill since then. Since the 1980s, corporate income taxes have provided about 10 percent of federal revenues, a share equal to 1 to 2 percent of the economy. In 2004, a year of historically high business profits, corporate income taxes as a share of the economy came to 1.6 percent.

Corporate tax sheltering is now rampant. It "has become cheaper and spread by imitation, as more and more companies get away with it," writes Daniel N. Shaviro, a professor of taxation at New York University Law School and a visiting scholar at the American Enterprise Institute, in his recent book "Corporate Tax Shelters in a Global Economy."

Trying to minimize tax liability is not inherently abusive, Mr. Shaviro says, but "aggressive tax sheltering that crosses or even nears the boundaries of what is legally permitted can have negative effects on broader social norms of tax compliance."

On that point, there is no doubt. One of the biggest tactics for sheltering corporate income right now involves overseas profits. American companies are increasingly looking huge profits in foreign tax havens, where the money is out of the reach of the I.R.S. A study last year by Martin Sullivan, a former Treasury Department economist, showed that American multinationals reported a record $149 billion of profit abroad in 2002. Some of the companies have no legitimate business operations abroad. Many others have bona fide business interests, which are often coupled with aggressive tax avoidance strategies.

In 1998 and 1999, the I.R.S. tried to close a major loophole that allows American companies to shift their profits overseas. But a massive lobbying effort by business interests persuaded Congress to block the effort.

Rather than support efforts by the Treasury to enforce existing law, time and again Congress has intervened to help companies shelter their profits. The corporate tax bill signed into law by the president last year included $140 billion in new corporate tax cuts, including $43 billion specifically for companies with overseas operations.

This year, this kind of tax avoidance hit a new low. Congress declared a special one-year tax holiday for 2005, during which American companies can repatriate foreign profits at a tax rate of 5.25 percent - an 85 percent discount off the normal corporate rate. That means that companies are actually being rewarded for years of avoiding taxes by parking profits overseas. By year's end, an estimated $300 billion in profits may have found its way home at the reduced rate. Such a huge giveaway to corporations is good news for shareholders,
future, because companies are rushing to bring home profits at this year's bargain-basement tax rate.

A thoughtful approach to corporate taxes in a global economy might reveal that an entirely new system is needed, with closer cooperation between countries to prevent artificial shifting of profits among them. But the powers that be are not having that debate. Rather, something completely predictable is happening - overt corporate giveaways, yet another form of shielding those at the top from taxes.

**Higher Taxes on America's Paychecks: The Rise, and Rise, of Payroll Taxes**

At the same time that the taxes investors pay - estate, capital gains and corporate - have gone down as a share of federal revenue, taxes that workers pay have grown. In 1980, 31 percent of federal revenues came from payroll taxes, which are paid by everyone who works for a living. In 2004, 39 percent did.

Payroll taxes are sharply skewed against the lowest wage earners. In 2004, the average payroll tax rate for workers making $50,000 to $75,000 was 12 percent. For someone making more than $1 million, it was just 1.5 percent.

The reason for this imbalance is that a large portion of the wages of highly-salaried people are exempt from payroll taxes. This year workers and employers will each pay a 6.2 percent payroll tax, which is earmarked for social security, on all workers' wages up to $90,000. Wages above $90,000 are not subject to the tax. (Workers and employers will also each pay a 1.45 percent payroll tax on all wages, with the proceeds going to Medicare.) The hit is even bigger than it seems. Although workers pay half and employers pay half, most economists agree that workers ultimately bear most or all of the employer's share in the form of lower wages and salaries.

The tax system is now so out of whack that the vast majority of Americans now pay more in regressive payroll taxes than they do in progressive income taxes.

Regressive as they are, payroll taxes are actually becoming more so. The amount of income that the tax is applied to has not kept up with the income gains of the highest-paid workers. In 1983, only 10 percent of total wages escaped the payroll tax. Today, 15 percent does - wages earned by those with the highest salaries.

It gets worse still. Payroll taxes have long exceeded the amount needed to pay for current Social Security benefits, creating a surplus in the Social Security trust fund. (The surplus is currently $173 billion annually).

At the same time, however, the rest of the government is running a deficit, currently $504 billion, caused in large part by various tax cuts on investment. The "official" deficit is therefore $331 billion. ($173 billion trust fund surplus minus $504 billion budget shortfall.) In effect, the surplus - which comes from taxes paid by working people at the middle and lower rungs of the income ladder - is being used to mask the true cost of today's deficit-financed tax cuts on estates, capital gains and corporations.

It wasn't supposed to be this way. Excess payroll tax revenues were intended to build up a cushion to pay Social Security benefits to baby boom retirees. The payment of those benefits - akin to a "return" on one's taxes - would erase the painful regressivity of the tax.

If current high-end tax cuts continue, however, the deficits they provoke will make all government programs vulnerable to cuts, including Social Security, even though workers have been paying high payroll taxes for decades precisely to avoid that outcome.

In this way, tax cuts for the rich are fomenting a crisis for everyone else. The Bush tax cuts are especially damaging because of their size, and because they are occurring just as baby boomer begin to retire. If the Bush tax cuts were allowed to expire, their revenue would be far more than enough to close the long-term funding gap in Social Security, without cutting benefits. But the Bush administration wants to make them permanent.

**Saving the Beast**

There are two things going on when taxes on the rich are cut as drastically as they are being cut right now. The tax burden is shifted downward and lower tax revenues "starve the beast" - conservative-speak for forced reduction in government programs.

The non-rich are hit twice. They are forced to bear more of the nation's tax burden, and they lose needed government programs.

Congress is poised, despite Katrina, to cut back on an array of government programs - because the taxes have been rigged in a way that means we can no longer afford them. It has aimed its scalpel at programs that serve the poor, like Medicaid and food stamps, and ones that Americans of all incomes rely on - infrastructure spending, environmental protection and, yes, disaster relief. And as recent history and budget trends suggest, Social Security and Medicare are also at risk of deep cuts in the not too distant future unless the tax system is restored to sanity.

In 2001, President Bush endorsed starving the beast when he described a probable decline in federal revenue as "incredibly positive news" because it would "put a straitjacket" on government spending. Or, as Grover Norquist, a prominent leader of the anti-tax, anti-government movement put it in 2001 - in a phrase that has chilling reverberations after Katrina - the goal is to get government "down to a size where we can drown it in a
Americans have never truly bought into that philosophy - despite all of the talk about the popularity of cutting taxes. Polls show that respondents have a knee-jerk preference for lower taxes. But they also show an increased willingness to pay up when the alternatives - less effective government and growing inequality - are pointed out to them.

The speed with which Congress tabled its tax-cutting agenda after Katrina - temporarily, at least - indicates that lawmakers know that such actions do not reflect the will of the people.

Katrina has changed the calculus on tax cuts, by reminding Americans of the importance of government in their lives - and by implication, of the importance of taxes. Before Mr. Bush even took his first trip to flood-ravaged New Orleans, he said in an interview that the Gulf Coast could be rebuilt without raising taxes. Perhaps Mr. Bush's comment was a tacit way of trying to convince the public that a major issue underlying the Katrina disaster - who should pay for government and how much - has been resolved.

It hasn't.

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