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Economic analysis shows why Buffett tax view off-base

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Midlands Voices:

Economic analysis shows why Buffett tax view off-base

By Seth H. Giertz

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Recently in the New York Times, Berkshire Hathaway CEO Warren Buffett had advice for Congress's debt panel: Raise my taxes.

For several years, Buffett has lamented his low tax liability. He contends that he is not paying his fair share because he pays just 17.4 percent of his taxable income to Uncle Sam, while others in his office who are much less well off pay an average of 36 percent.

Buffett wants Congress to raise taxes on incomes over $1 million and raise them further for those making over $10 million. In particular, he wants taxes increased on capital gains and dividends, which are taxed at lower rates than ordinary income and represent a much larger share of income for the "super rich."

Politicians and economists have taken various positions on this issue, but the main justification for Buffett's proposal — his comparison of tax liabilities — is misleading.

From the perspective of consumption, the capital gains tax (and other taxes on savings) represents an added penalty to savings. On first blush, it appears capital is treated more favorably than labor. After all, for those in the top federal tax bracket, marginal income tax rates on wage and salary income are 35 percent, versus 15 percent for long-term capital gains.

However, consider a high-income taxpayer with $100 of additional earnings. Consuming immediately implies a $35 federal income tax liability. On the other hand, savings incurs this same $35 tax liability plus capital gains taxes on returns to the after-tax savings. For example, at

5 percent annual return, the $65 in savings grows to over $140 after 10 years. Of this $140, $75 ($140 minus $65) is subject to the 15 percent capital gains rate, resulting in an additional $6 of tax (or $4 in present value terms).

In this case, saving $100 of earnings results in taxes of $39 — four percentage points higher than earnings that are used for immediate consumption. This is why those who favor consumption tax, as opposed to an income tax, would eliminate taxes on capital gains and on savings more generally.

It is noteworthy that Buffett has supported a consumption tax; several years ago he told Tom Brokaw that "a progressive consumption tax makes the most sense ... tax the people who use the resources of society rather than ones who provide the resources."

An important factor omitted in my example and in Buffett's measure is the corporate income tax. Before capital gains or dividends are paid, corporations pay corporate taxes on their earnings — generally at a 35 percent rate. Under reasonable assumptions, this would increase the tax liability in my example by more than $19, raising the overall average tax rate to more than 60 percent.

Economists find that taxes are often a consideration in businesses decisions. Even President Barack Obama has indicated that he is in favor of lowering the corporate rate.

Another source of confusion: Buffett measures "statutory incidence," which is based on which party remits the tax to the government. Statutory incidence is often a poor proxy for what economists call "economic incidence," which measures the true burden from taxes.

In 2007, economists Thomas Piketty and Emmanuel Saez carried out a meaningful comparison of average tax rates accounting for economic incidence. Contra Buffett, Piketty and Saez find that economic incidence from federal taxes increases with income — all the way through to the top 0.01 percent of the income distribution. In fact, the "super rich" paid between 33 and 35 percent of their income in federal taxes. For comparison, the share paid by those between the 80th and 90th percentiles was about 23 percent.

Piketty and Saez do, however, show that the degree of progressivity at the top of the U.S. income distribution has lessened considerably in recent decades. The Bush tax cuts lowered the share of taxes for all income groups, while the share of income at the very top of income distribution has grown rapidly.

This has led some to endorse policies similar to those proposed by Buffett. But it is misleading to suggest that the "super rich" pay federal taxes at half the rate of those with more pedestrian tax returns.

The 1040 form tells only part of the story, especially when comparing people with very different income sources. Economic measures of tax incidence show that federal taxes are in fact progressive and not highly regressive.

Hopefully, with this information, Buffett will sleep a little easier at night.