

Should the richest people pay more taxes

Problem: The United States is a massive, almost \$20 trillion, economy that is largely based on the private sector. About two thirds of total expenditures are made by private individuals for consumption or investment purposes. However, about one third of this vast GDP is spent by Federal, State, and local governments, partly to purchase goods made by the private sector (e.g., military supplies) and partly to produce goods and services directly (e.g., public schools). What is not always appreciated is that most of these public expenditures are absolutely needed to maintain a vibrant, dynamic, and prosperous private sector. Without the development of a talented and healthy workforce, without the assurance of law and order, without the enforcement of contracts, without an efficient highway system, without the assurance of safe and clean water, and without many other public services, the private sector, along with its abundant production capability, would quickly deteriorate.

The problem is that these public services must be funded. The usual method is by the use of a variety of taxes which a large number of citizens resent, often because they do not see a proportionate relationship between the public benefits they receive and the taxes they pay. As examples, people without children may wonder why they should be asked to help pay for public schools; healthy people may ask why they should help pay for the health care of people who cannot afford health care; wealthy people may question why they should pay more taxes than those less fortunate, etc. For whatever reason, proposals to lower taxes receive wide support, particularly among persons who have the highest incomes.

The issue is not whether most public expenditures should be paid by taxes. The issue is how this unwelcome burden should be distributed among the population. To be more precise, given the enormous share of our annual national income which accrues to the top 1 percent of the population, about 19 percent, and given our chronic excess of public spending over public revenues, should this richest part of the population be asked to pay higher taxes than at present. This is an unresolved issue which sharply divides the nation and often determines the outcomes of elections.

Thoughts on possible solution: Economists have two basic theories on how taxes should be allocated. One is the “ability to pay” approach, and one is the “benefits received” approach. The “ability to pay approach” argues that the more income that people receive, the more that they should pay in taxes. The Federal income tax (and some state and local income taxes) in the United States is based on this principle; in fact, the Federal income tax increases not just the amount of tax as income rises, but also the percentage of income paid in taxes as income rises. This is termed a progressive tax. If the percentage of income remained constant as income increased, it would be termed a proportional tax, and if it decreased as income increased, it would be termed regressive.

There are of course other justifications for taxes, e.g., taxes could be based on how much people consume (luxury or sales taxes), how much wealth they possess (property and estate

taxes), undesirable habits (tobacco and alcoholic beverages taxes). However, our focus here is on income taxes.

The problem with the “ability to pay” approach is that it gives little guidance on what tax rate should be levied on different income levels. Sometimes advocates for lower taxes on the rich will argue that it is unfair to impose high taxes on them simply because they work hard and take risks in order to earn this high income, an argument that is not easily disposed of. And, sometimes it is argued that taxes should be lower on rich people because on the belief that high personal income tax rates discourage people from working. This latter assertion is based on the belief (by some) that higher taxes reduce the net income from working and discourage some people, especially those in high tax brackets, from work.

This latter argument has led a few people to believe that lowering taxes would increase work effort (and the willingness to invest) and could even have the paradoxical effect of increasing tax revenues. The problem is that there is not a shred of evidence to support this belief. Empirically, whenever taxes have been lowered, tax revenues have declined (and the federal deficit increased) and there appears to have been little effect on the amount of work performed. In fact, reducing the net return per hour of work may have the opposite effect. Workers with less money may feel it necessary to look for additional work to pay rent, car and house payments, etc. This is not to argue that there may not be a few people for whom higher tax rates would discourage work. The most important groups may be mothers with young children who are faced with high costs for child care, and perhaps a few part-time workers whose income, and marginal tax rate, is otherwise quite high. However, any reduction in work effort is likely to be minimal.

What guidance on the appropriateness of tax rates on very rich people can be gleaned from the “Benefits approach” to taxation. At first glance, one might be tempted to conclude that all people benefit roughly equally from good roads, sending their children to public schools, law enforcement, etc. But think. The reason why very rich citizens are able to make incomes running into the millions and sometimes billions per year is precisely because they live in a country that offers enormous rewards to enterprising and talented individuals. These enterprising and talented individuals have available large markets, efficient road systems, an educated, healthy, and motivated work force, and many other assets largely provided through tax funded programs. Their very high incomes are absolutely dependent upon the existence and maintenance of these programs.

Thus, under the “benefits received” approach to taxation, it would appear reasonable to expect these individuals to pay a substantial part of the costs of government services that make their high earnings possible, in fact, considerably more than people with only average earnings. In fact, I suspect that it would be possible for high income earners to pay considerably more than at present with no significant impact on the amount of work they perform.

But alas, neither the “ability to pay” or the “benefits received” approach provides clear guidance on how much more they should pay to fund the programs that make their very high incomes possible. The top 1% of wage earners will almost certain complain that they already

pay over a third of all Federal income taxes. True enough, but what is often forgotten that all wage earners, rich and poor alike, pay about 15% of their earned income taxes in payroll taxes and that the mainstays of state and local governments, sales and property taxes, are paid by almost all citizens and are highly regressive, i.e., the poorer a person, the higher the percentage of income paid in taxes.