



Joint Economic Committee *Republicans*

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REPUBLICAN STAFF COMMENTARY

Atlas Shrugs: The Diminishing Returns from Taxing the Rich

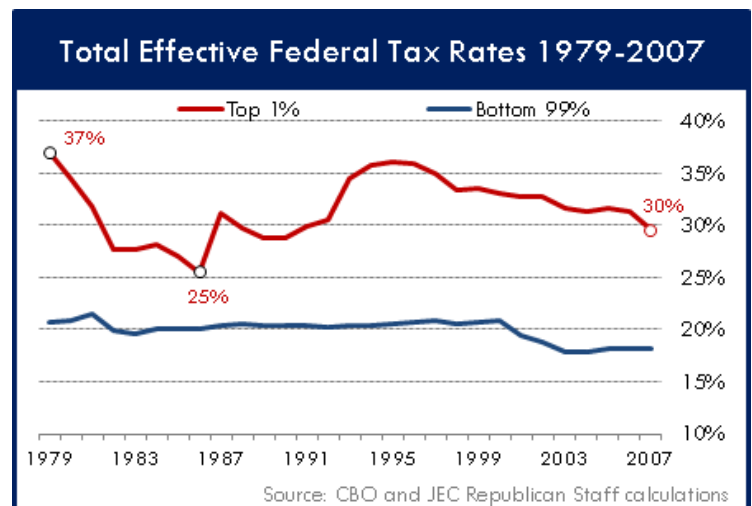
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President Obama claims there are many reasons to raise taxes on the rich – “It’s only fair.... They can afford it.... They get the most, so they should give the most.”¹ But, ultimately, President Obama’s case for taxing the rich rests on the axiom attributed to the notorious bank robber Willie Sutton. Just like robbing banks, that’s where the money is. By taxing the rich, President Obama hopes to avoid politically difficult reductions in other government programs. But raising taxes on the richest Americans will generate only a fraction of the expected revenue. Rather than a political panacea for our nation’s deficit woes, taxing the rich is largely a self-defeating proposition.

Higher effective tax rates on the top 1% reduce their income by enough to offset 70% of the expected revenue increase.

Does Atlas Shrug?

The Congressional Budget Office (CBO) publishes data on pre-tax income, post-tax income, and average federal tax rates (tax rates as a percentage of income) paid by households in various income categories for the four largest sources of federal revenues--individual income taxes, social insurance (payroll) taxes, corporate income taxes, and excise taxes. The effective federal tax rate incorporates all four major sources of revenue, not just individual income taxes.²



The effective federal tax rate on the richest Americans has varied significantly in recent decades. For the Top 1% of income earners, tax rates have ranged from 37% in 1979, to 25% in 1986, to 30% in 2007.³ This variability provides a natural experiment in which to analyze the effects of higher tax rates.

¹ President Obama’s remarks at George Washington University, Washington, DC, April 13, 2011.

<http://www.whitehouse.gov/the-press-office/2011/04/13/remarks-president-fiscal-policy>

² Effective tax rates measure total taxes as a share of total income, in contrast to marginal tax rates that measure the additional taxes paid as a result of earning an additional dollar of income.

³ Congressional Budget Office, Average Federal Tax Rates and Income by Income Category (1979 to 2007), June 2010.

<http://www.cbo.gov/publications/collections/collections.cfm?collect=13>

Many people believe the rich always get richer and tax rates are irrelevant. Proponents of this view fail to acknowledge any link between the two. In their view, tax cuts for the rich simply represent an undeserved windfall. To the contrary, the evidence shows without the tax cuts the rich would not have earned and reported so much taxable income. Conversely, higher tax rates will reduce their taxable income, thereby offsetting most of the expected revenue increase.

Diminishing Returns from Taxing the Rich

Based on the historical relationship between effective tax rates and pre-tax income, the table below shows the expected revenue from a hypothetical tax increase on the Top 1% of Americans.⁴ Specifically, it assumes the effective tax rate in 2007 is increased to the level that prevailed in 1979.

Column (2) shows the amount of revenue collected in 2007 at the 2007 effective tax rate. Column (3) shows the amount of revenue expected to be collected in 2007 at the 1979 effective tax rate, assuming no change in pre-tax income (Static Estimate). Column (4) shows the amount of revenue expected to be collected in 2007 at the 1979 effective tax rate, assuming pre-tax income responds as it has in the past (Dynamic Estimate).

Static and Dynamic Revenue Effects of Higher Taxes on the Top 1% (in Billions of Dollars)			
(1) Households by Income Percentile	(2) Revenue in 2007 at 2007 Tax Rates	(3) STATIC ESTIMATE Revenue in 2007 at 1979 Tax Rates	(4) DYNAMIC ESTIMATE Revenue in 2007 at 1979 Tax Rates
Top 1%	\$631	\$790	\$676

Source: CBO and JEC Republican Staff calculations

Instead of collecting an additional \$159 billion (3)-(2), the government would collect an additional \$45 billion (4)-(2), or about 30% of the expected revenue increase.⁵

Some might be tempted to take whatever they can get. After all, \$45 billion is better than nothing. But this analysis only reflects the effects of higher taxes on the Top 1%. It does not include the economy-wide effects on jobs, income, and investment. That will be the subject of a subsequent JEC analysis.

Conclusion

Contrary to what “soak the rich” advocates might have us believe, the rich are not mindless ATMs ever ready to dispense more cash. Most are entrepreneurs, executives, and investors. They respond rationally to economic incentives. When the government increases their effective tax rate, they will work, save, and invest less. That means much less revenue than expected.

⁴ The Top 1% of households had adjusted income greater than \$352,900 in 2007. See Footnote 3 for data.

⁵ The elasticity of income with respect to taxes is -0.69. That means a 10.0% increase in the effective tax rate will reduce pre-tax income by 6.9%. These results are based on an ordinary least squares regression (in logs) of the annual pre-tax income of the Top 1%, the annual pre-tax income of Bottom 99%, the average annual unemployment rate, and the effective federal tax rate on the Top 1% for the years 1979 to 2007 ($R^2 = 0.98$). See Footnote 3 for data.