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The Top 1% Are Not Evil

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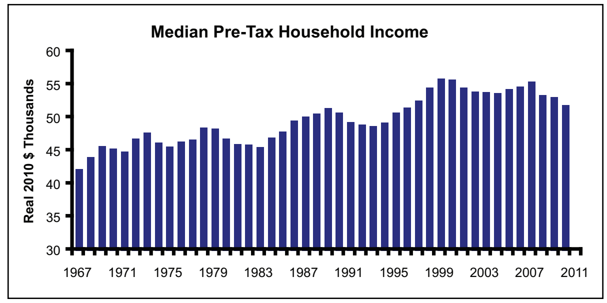
While much media attention was given to the "Occupy" movement, little attention has been paid to who constitutes the "1%" they despise. Who are these "elite" earners? Most are surprised to learn that the 1% cut-off is $344,000 of adjusted gross income (based on 2009 tax data). There is no doubt that this is a very comfortable income, but a family in suburban Philadelphia or Long Island earning $350,000 is not living large. And certainly their comfort is not at the expense of the other 99%. Ironically, many households with two government employees breach the top 1%!



Lost in the class warfare rhetoric is the basic fact that from its pre-recession high, the U.S. has lost nearly $9 trillion in real household wealth, most of which has been concentrated among the nation's wealthiest households. This roughly 25% decline in real per capita household net worth continues to hamper the housing market, particularly for second homes.

Realize that U.S. per capita disposable real income was $25,607 in February 2001, rising to a peak of $33,424 in June 2008. It subsequently fell during the recession to $32,009, and stands at $32,800 today, which is about where it stood in December 2007. That is, over the last four years, we have not improved our living standards. But objectively, this living standard is still staggeringly high by historical and global standards, as witnessed by the fact that 2007 was clearly a strong economy!

In fact, the rhetoric about the economic gains of "the top 1%" versus "the other 99%" of American households is absurd. While it is true that the top 1% of American households in 2010 had an average real income 300% higher than did the top 1% 30 years ago, far more important is the fact that the other 99% experienced a 40% increase in real income over the same time. And a 40% real income increase over 30 years is a monumental achievement, meaning that these households live far better than they did 30 years ago. This 40% increase means that there are far fewer households making what was once viewed as a respectable upper-middle-class income.
For example, 30 years ago $40,000 (in today's dollars) was viewed

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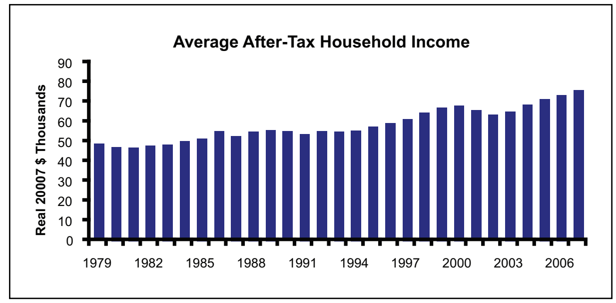
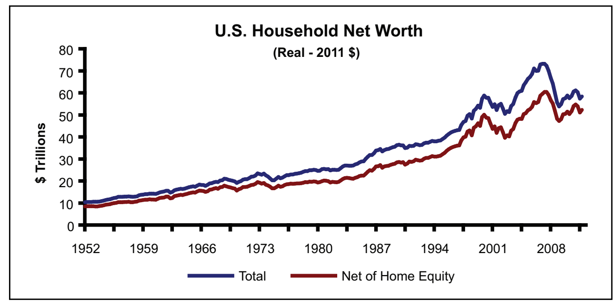
as solidly middle-income. But today this family has $56,000 in real income, which would have placed them comfortably in the upper-middle part of the income distribution of 30 years ago. Similarly, a household with $60,000 real income 30 years ago now has $84,000 in real income, which would have placed them well into the top 10% 30 years ago. Even a household that 30 years ago had an income of a mere $20,000 (in today's dollars), today has $30,000 in real terms — a 50% increase — when one takes into consideration various government transfers and subsidies as well as real income growth. While this may not seem like much of an improvement to those in ivory towers, it is a dream come true for these poor families.

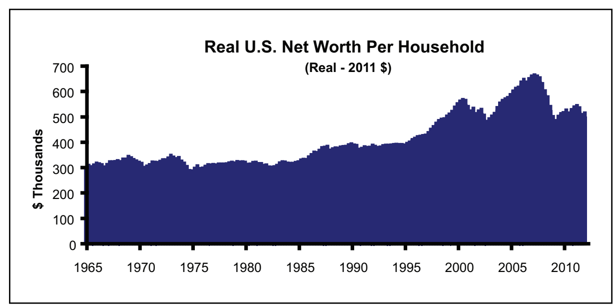
It is equally important to understand the fate of those in the top 1% 30 years ago: most of them are dead! That is, it is not the same households that are in the top 1% (or in the bottom 10%) throughout this 30-year period. Most households that were in the top 1% 30 years ago are long dead today, as they were then in their 50s and early 60s and at the peak of their earnings profiles. Thirty years later, these individuals are mostly deceased and have been replaced in the top 1% by a new generation of 50- and 60-year-olds who were quite low in the income distribution 30 years ago, as they were then 20-30-year olds early in their careers, and generally in the lowest quarter of the income distribution. Thus, what sounds like a comparison of the same people over time is in fact nothing of the kind. Many in the lowest 20th percentile 30 years ago are in the top percentile today, while many of today's lowest 20th percentile were not even born 30 years ago — though many will be among the nation's top 1% in 30 years, when they are 50-60 years old.

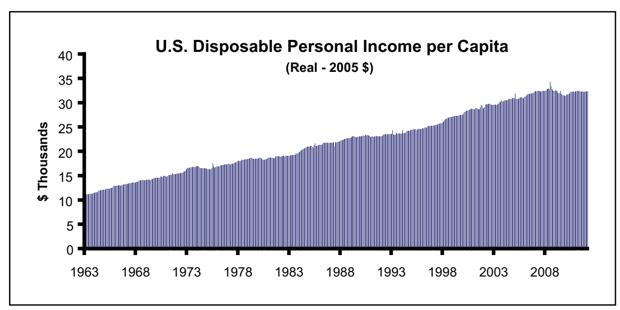
The average U.S. standard of living has risen to unimaginable levels relative to 30 years ago, and even more so versus 50 years ago, when JFK presided over Camelot. It is also critical to remember that had the top 1% only had an income increase of 200% (instead of 300%), it also would have meant lesser income growth for everyone else. Simply stated, contrary to Marxist assertions, the rich being richer does not mean anyone else is poorer. The rich today are richer because they have greater levels of productivity and tap into larger global markets than at any time in history. Those who successfully operate in these markets reap previously unattainable bounty.

Jealousy is an ugly trait, deplored by almost every social code ever devised. It clearly should not be the foundation of our economic policy. We are becoming increasingly like Western Europe in our economic jealousy, being more concerned about how well others are doing than with our own achievements. This is vividly reflected by the fact that Mitt Romney's financial success (in contrast to his







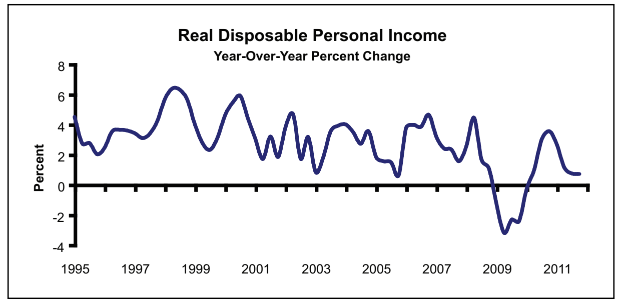


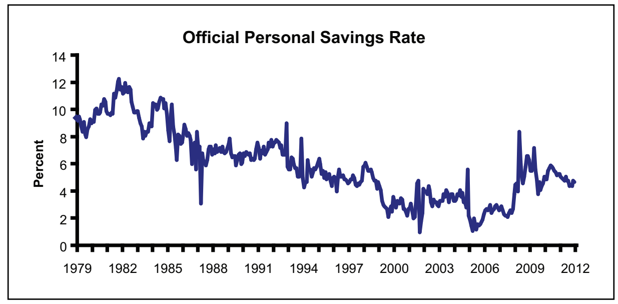
weakness as a campaigner) is his primary political liability. Were wealth a negative in our country, Washington, Jefferson, FDR, and JFK would have all been unfit to be president. These four presidents were all very wealthy when elected, yet they are usually ranked among the top 10 in U.S. history. Further, all modern presidents end up wildly wealthy, irrespective of their economic status when they are elected, thanks to post-presidency book deals, the speech circuit, and corporate boards. Does anyone doubt that President Obama is well on his way to achieving staggering wealth?

The fuss over Mr. Romney's taxes underscores how broken our federal tax system is today. Taxes have been changed from a means to collect revenue into a tool for social policy. But many of these social policies are contradictory, and no one can fully model their complex interactions. The only thing that can be said with certainty about our tax system is that it is very expensive and time-consuming for taxpayers.

When you see an honest person paying a low average federal tax rate, it means that they do what lawmakers want them to do in terms of their consumption, savings, and investment decisions. For example, vices such as gambling, smoking, alcohol consumption, and gasoline consumption are all heavily taxed, despite the fact that all of these activities are known to impose relatively high burdens on lower-income households. Yet at the same time, we have a progressive tax rate system that taxes those with higher incomes at higher incremental tax rates. We also collect taxes from corporations, meaning that corporate owners (but not lenders) pay taxes on corporate cash flows, and again as dividends are received or shares are sold. The result is that those with high investment income from dividends or capital gains pay a far higher total tax rate (corporate plus individual income) than is indicated by their personal income tax payments, as this measure omits their indirect corporate tax burdens.

Other social policies embedded in our tax system encourage individuals to invest by allowing depreciation deductions, and encourage individuals to save by taxing long-term investment income, sweat equity, and capital gains at lower rates. And if individuals give to charity or invest in municipal bonds (in order to reduce the cost of municipal finance), they also pay lower taxes, as Congress has decided that these are socially desirable activities. Further, the 31% of U.S. households that deduct mortgage interest and property tax payments on their homes are not avoiding taxes, but rather doing exactly what the tax code encourages them to do, namely owning highly leveraged homes.

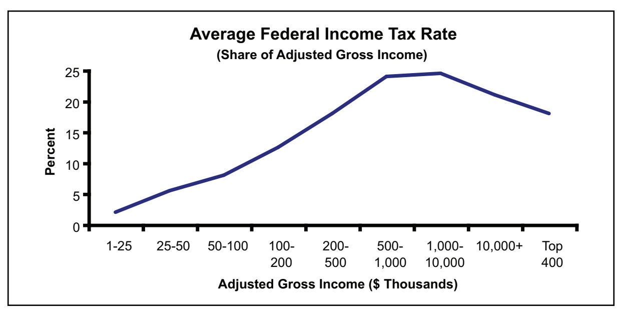




Breakdown of Income and Taxes by Category

Income Category	2009 Adjusted Gross Income Cutoff	% of All Income	% of Federal Taxes Paid	Tax Share to Income Share Ratio
Top 1%	Over $343,927	17%	37%	218%
Top 2-5%	Over $154,643	15%	22%	147%
Top 6-10%	Over $112,124	9%	11%	122%
Top 11-25%	Over $66,193	23%	17%	74%
Top 26-50%	Over $32,396	21%	11%	52%
Bottom 50%	Under $32,396	13%	2%	15%

Source: IRS, Kiplinger, Linneman Associates



So when someone has a low average tax rate, all it says is that they are doing what Congress wanted them to do: avoid vices, save long-term, give money to charity, use debt to buy a home, support municipal debt, etc. Instead of pillorying such people, we should say, "Thank you very much for doing what the government asked, because by doing so, you have furthered the social objectives sought by our elected officials." Instead, these law-abiding citizens are widely viewed as shirkers.

A 2011 Congressional Budget Office study (using Bush-era 2007 tax returns) reveals that the top 1% of American earners have an average income tax rate of 18.8%, versus 11.8% for those in the 2nd-20th percentile, 4.2% for those in the 21st-80th percentile, and -5.6% (negative due to various tax credits) for the bottom 20th percentile. As a benchmark, recall that at that time the federal government was spending about 21% of GDP. When the CBO analysis is expanded to incorporate both direct and indirect federal taxes (for example, including the impact of cigarette taxes, gasoline taxes, and social security taxes, as well as the burden of corporate taxes, etc.), the top 1% has an average tax rate of 29.5%, versus 22.8% for those in the 2nd-20th percentile, 15.1% for those in the 21st-80th percentile, and 4.7% for those in the bottom 20th percentile. That is, the rich consistently pay a far greater proportion of their income in the form of federal taxes than do lower-income households. And none of these segments pays on average more than about 30% in federal taxes. The highest strata of the income distribution pay taxes far disproportionate to their incomes. Hence, while those in "the 1%" have a tax burden 2.18X their income share, the rest of society bears just 0.76X its income share. In fact, everyone in the bottom 90% bears a burden less than their income share.