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Subject: J.P. Morgan Eye on the Market 10/17/2011: The Tell-Tale Heart

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Inline-Images: image002.png; image003.png; image005.png

Eye on the Market, October 17, 2011

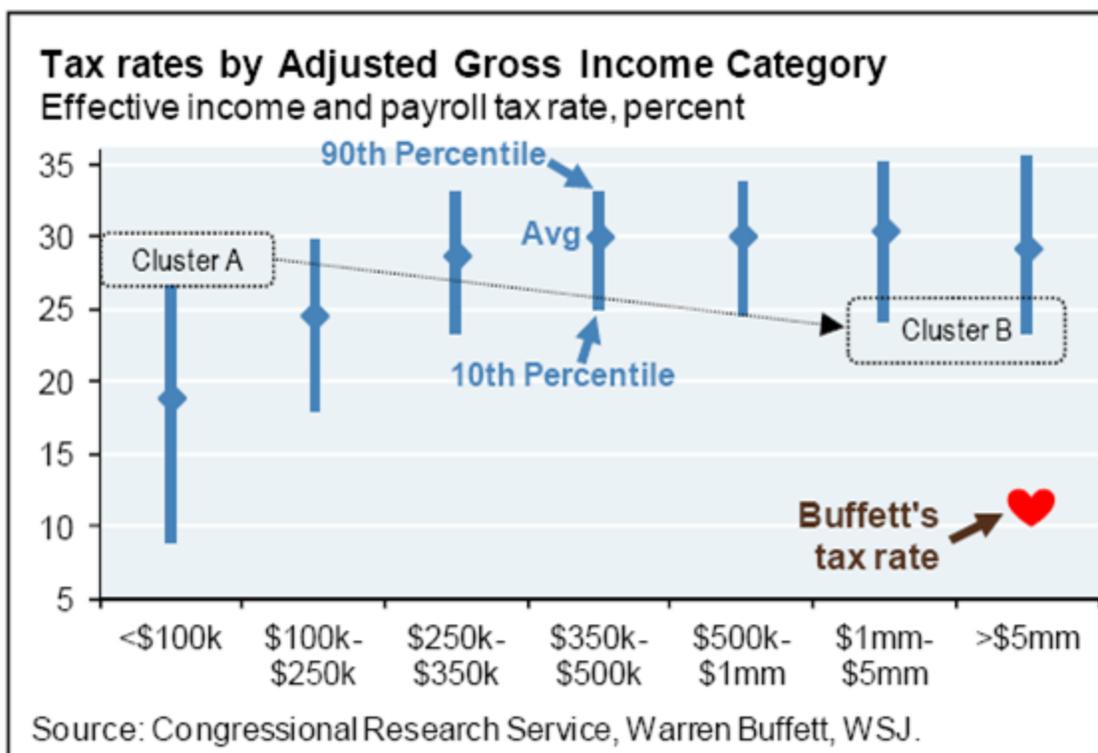
Topic: Do U.S. millionaires, as a group, really pay lower tax rates than their receptionists?

Recent US data (payrolls, retail and vehicle sales, manufacturing surveys) have come in a bit better than expected (see p2); we'll know more when we get October business and employment reports in early November. We maintain the view that the US will avoid a recession, despite substantial austerity in 2012. As for Europe, Godot is finally scheduled to arrive next week (in the form of a bank recap/ sovereign debt backstop plan, just in time for a European recession and credit contraction). We will have more to say when he does; there is scope for considerable disappointment here after the recent 16% rally in European equities.

The Tell-Tale Heart. Warren Buffett, perhaps the best-known investor and philanthropist in the US, participated in the creation of his eponymous rule out of concern that the ultra rich "as a group, are paying less of their income to the federal government than their receptionists". It would be quite an indictment of the progressivity of the US tax system dating back to the 16th amendment in 1913 if it were true. Given the controversy, the Congressional Research Service (which analyzes these issues for congressional committees) took a look at the Buffett Rule as described in the President's deficit reduction plan:

Buffett Rule: no household making over \$1 million annually should pay a smaller share of its income in taxes than middle class families pay. This rule will be achieved as part of an overall reform that increases the progressivity of the tax code.

The CRS study provides effective tax rates (including payroll taxes) for a range of incomes. We created the chart below, with each line representing the distribution of tax rates within that category; the dot is the average. Example: tax rates range from 25% to 34% for those making \$500k to \$1mm per year, with an average of 30%. CRS excluded the 10% tails on both ends of each distribution. We also super-imposed our own estimate of Buffett's effective tax rate, based on disclosures in the WSJ.



There is a lot to think about here. I made a short list.

[1] The tax code is progressive, as shown by rising average tax rates from lower categories to higher ones. Above \$500k in adjusted gross income, progressivity flattens.

[2] Effective tax rates vary widely within each category (and probably always will), due to the unique circumstances of individual taxpayers. For example, many taxpayers in the 2nd category pay higher rates than taxpayers in the 3rd.

[3] CRS highlights that the top ten percent of filers in the lowest income category pay a higher tax rate than the bottom quartile of millionaires. In other words, taxpayers in Cluster A pay higher tax rates than taxpayers in Cluster B. What should one conclude from this? **As a general approach to tax policy, principles behind the Buffett Rule look like they are already followed:** tax rates of the vast majority of lower income households are much lower than those paid by higher income ones (in part a reflection of the AMT, created in 1969). However, defined as a binary litmus test that can never be violated by a single taxpayer, it is not.

[4] Since tax policy is more like horseshoes than skeet shooting (e.g., get as close as you can and then accept the unavoidable dispersions), does it make sense to draft legislation based on absolutes like this? Do we have absolutes anywhere else in the tax code? The stated precision of the Buffett rule ignores these inherent dispersions, and thus takes on the air of deliberate political rhetoric rather than serious tax policy.

[5] If our estimates are correct, Mr. Buffett's tax rate is so far below others in his income category, that he would be the ideal poster child for such a rule. Like Edgar Allen Poe's *Tell-Tale Heart*, perhaps the constant thumping of this abnormally low tax rate became too loud for him to ignore. **However, one taxpayer's outlying experience should presumably not form the basis for national tax policy, no matter how well-intentioned.** The CRS data, as far as I can tell, *rejects* Buffett's hypothesis that millionaires "as a group, are paying less of their income to the federal government than their receptionists". For what it's worth, a 2008 study of OECD countries showed that the share of income taxes and payroll taxes paid by the top decile in the US, relative to their income, was the highest of all 30 countries analyzed.

[6] If there's consensus that the progressivity needs to be increased on the top 3 categories (e.g., that *average* tax rates should keep rising), let's have an informed dialogue about why and how. That makes more sense than repeating Twitter-friendly comments about millionaires and receptionists. Some things take more than 140 characters of text to discuss.

[7] There is a lot of emotion and frustration in the air (and in the streets) regarding the slow pace of recovery, Chinese currency intervention, the loss of US manufacturing jobs, and Congressional debates on tax/entitlement policy. The creation and propagation of misleading hypotheses about the progressivity of the country's tax code isn't helping.

Notes and Sources

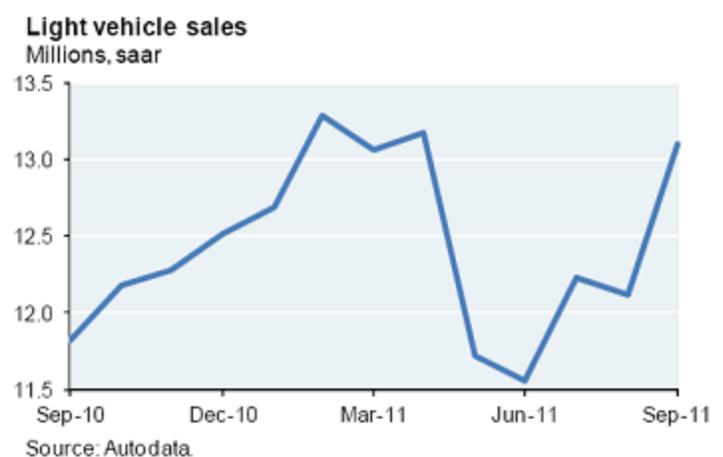
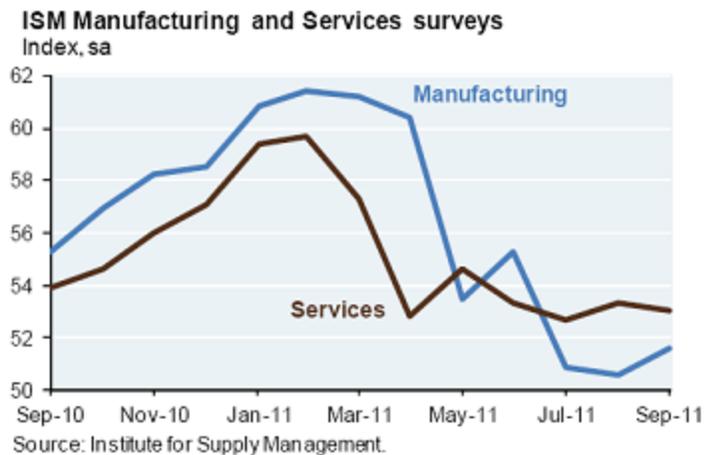
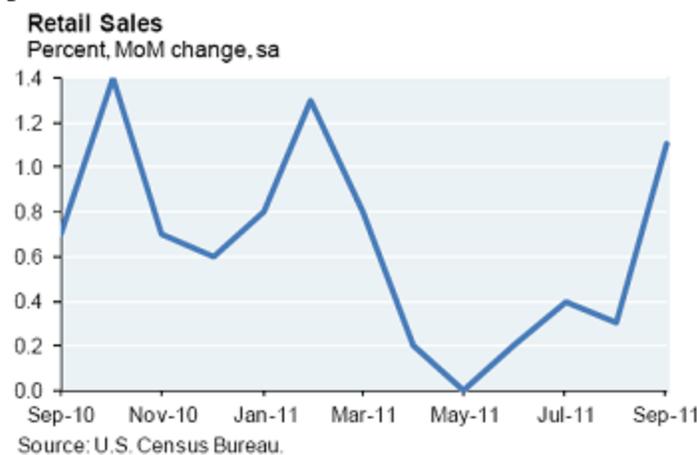
** Warren Buffett quotation as reported by the Wall Street Journal on October 13, 2011, in a letter to Congressman Tim Huelskamp (R-Kan). Buffett’s estimated effective tax rate is based on the following disclosures: 2010 adjusted gross income of \$62,855,038; taxable income of \$39,814,784; \$15,300 in payroll tax, and \$6,923,494 in federal income tax.

** The source for the data in the chart is a report entitled “An Analysis of the Buffett Rule”, Thomas Hungerford, October 7, 2011 from the Congressional Research Service. The CRS used what they describe as a representative sample of around 130,000 tax returns from fiscal year 2005. The split between the second and third brackets in the chart is \$250,000, which is the definition of “high income” for married taxpayers filing joint returns. For married couples filing separate returns, the dividing line would be \$125,000, and for single filers, it would be \$200,000.

** The CRS report also computes tax rates by income category after reducing income by personal exemptions, public assistance, and deductions for charitable contributions, mortgage interest and state/local taxes. However, as the author states, this measure of taxable income artificially increases effective tax rates by understating the resources available to pay tax. Almost every effective tax policy analysis I have ever read looks at taxes paid as a percentage of adjusted gross income, and it is not clear at all why the author bothered to include this additional calculation.

** OECD source: “Growing Unequal? Income Distribution and Poverty in OECD Countries”, Organization for Economic Cooperation and Development, 2008. Peter Whiteford, one of the primary authors of the report notes that the study “doesn’t include sales taxes, but these are much heavier in most other OECD countries, and not as progressive as direct taxes, so if you added indirect taxes in through some sort of modeling, it is almost certain that the US would still have the most progressive overall tax system.” Whiteford also stresses, however, that the highly progressive US tax system co-exists with a high level of wealth and income inequality compared to other OECD countries.

Recent US data modestly better than expected. Next up: a fiscal contraction in 2012



CRS Congressional Research Service
OECD Organization of Economically Developed Countries
AMT Alternative Minimum Tax

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