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Obama's Folly: Why Taxing the Rich Is No Solution

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The president should spend more time with the economic literature on taxes.

During the last three decades the wealthy in America have become wealthier yet. American capitalists today are richer than virtually any other group in any country at any point in history. At the same time, the United States is experiencing record deficits, which threaten to bring the economy to its knees.

It is therefore hardly surprising that the solution proposed by some is to raise taxes on the rich. President Obama has proposed doing so. Investing giant Warren Buffett made the case for taxing the wealthy this week in the New York Times.

In one respect, Obama and Buffett are completely right. The rich do not "need" to pay lower taxes, and can certainly "afford" tax increases. If raising taxes on the rich would solve the deficit without hurting the economy, we would support the president's tax policy in a heartbeat. It would certainly be a more equitable solution to lower the already astounding standard of living of hedge fund owners than to "cut some kids off from getting a college scholarship."

Unfortunately, the choices faced by America are not that simple. An economic strategy founded on raising taxes on the rich is based on two false premises. The first is that tax increases on the rich are a solution to current budget deficits. The second is the argument often put forward that there is "no evidence" that tax increases on the rich hurt the economy.

If you look carefully, President Obama has never explicitly stated that taxing the rich will bring in much revenue. Instead, the president has made sure to give voters the impression that the Republican refusal to tax the rich is the main cause of the deficit and thus the main obstacle to solving the fiscal crisis. For instance, Obama stated that "tax

cuts that went to every millionaire and billionaire in the country" will "force us to borrow an average of $500 billion every year over the next decade." This message has been widely repeated: Jon Stewart, for instance, has assured his impressionable audience that without the Bush tax cuts, future deficits would not be a major problem.

But how much revenue are we really talking about? According to the New York Times, the president's plan to abolish the Bush tax cuts for those making more than $250,000 is expected to bring in merely $0.7 trillion over the next decade, or about 0.4 percent of Gross Domestic Product per year. As a comparison, the Congressional Budget Office estimates that the deficit over the same period is going to be $13 trillion, more than 6 percent of GDP per year.

The rich in America obviously have lots of money, but there are simply not enough of them to fund the president´s preferred level of spending. For all the attention it has received, President Obama's "taxing the rich" policy can best be described as symbolic in nature, a rounding error compared to the deficits in the president's budget. Obama centers his speeches around tax hikes on the rich to lead voters into believing that hard choices on the economy can be avoided simply by taxing the rich at a higher rate.

Taxes and Entrepreneurs

Although the proposed tax increases will barely make a dent in the deficit, raising the top tax rates is likely to harm economic output. Many are convinced that tax increases have little or no damaging impact on the economy. We hear over and over again that notions of damaging effects from higher taxes are merely based on "trickle down" theory, which has been proven false.

This is not true. There exists robust empirical evidence that taxes impede economic activity. In conventional economics, only the magnitude of the negative impact of taxes on economic output is debated, not the existence of such an effect.

Let us focus on one such negative impact, the effect of taxes on the activity of business owners, an important segment of the economy. Business owners account for 40 percent of American capital, while firms with less than 500 employees employ half the private sector workforce.

The argument that taxes do not negatively affect small and medium-size business tends to rely on a number of fallacies. One example is an article by Berkeley economics professor Laura Tyson, a member of Obama's advisory board, which was published in the New York Times. In the article, she claims that "the relationship between tax rates and economic activity, even though it has superficial appeal, is not supported by the evidence."

The most common fallacy repeated by Tyson is that taxes do not matter because the economy was booming during the Clinton years even though taxes went up. But tax increases are not the only economic event associated with the Clinton years, and therefore cannot be claimed to cause all events that took place in his presidency. The Clinton years also contained entry into NAFTA, welfare reform, and recovery from the 1992 recession. Most importantly though, the Clinton years included the IT boom, which dramatically raised productivity growth in the United States as well as in other developed countries. It would strain the imagination to believe that Clinton's moderate marginal tax increase somehow caused the PC and Internet Revolution.

Instead of picking one historic event that happens to fit your preferred theory, a more reasonable approach is to investigate all historical periods where taxes increased or

decreased. This has been done by former Obama advisor Christina Romer and her husband David Romer. They also take into account the causes of tax increases.[1] They find that tax increases tend to reduce economic growth, stating that “tax increases appear to have a very large, sustained, and highly significant negative impact on output,” as “an exogenous tax increase of one percent of GDP lowers real GDP by almost three percent.” Similar results have been obtained by Harvard economist Alberto Alesina using a different methodology.[2]

Regarding small business, Tyson claims that “98 percent of small-business owners will not be affected if the Bush tax cuts for these brackets expire.” This is true, but also irrelevant. The United States has more than 25 million registered firms and more than 10 million self-employed. Most registered firms have zero employees and virtually no revenue, and exist for tax or legal reasons. Similarly, most self-employed businesses are small scale and employ no one other than the owner. What we are primarily concerned about is the impact of higher taxes on the small number of economically important firms. These are firms that collect sizable revenue, employ others and have the potential to grow and hire more workers. The owners of such firms are obviously far richer than the typical self-employed person, and are far more likely to be hit by tax increases on higher incomes or on capital gains.

According to the “World Top Incomes Database,” 28 percent of the income of the highest earning 1 percent of Americans, the group targeted by the president’s tax hikes and the group most likely to own successful firms, is constituted by entrepreneurial income.[3] This has implications for the wider economy. Following the 1986 tax reform, Princeton Professor Harvey Rosen and co-authors investigated the effect of the personal income tax of business owners on their hiring activity. Business owners who received larger tax cuts expanded their hiring more.[4]

This runs contrary to a common argument that taxes may matter for ordinary people, but not for the already rich or for entrepreneurs who care mainly about developing their company. Arianna Huffington, for example, has ridiculed the notion that the rich would care about and be affected by a few percentage points of higher taxes.

In fact, two groups that are consistently found to be *more* responsive to taxes than average are precisely the self-employed and high-income earners.[5] Both groups can more easily evade taxes and tend to have more control over their economic behavior. Looking at historic American tax reforms, economists Jon Gruber and Emmanuel Saez demonstrate that increases in taxes reduce taxable income especially for high-income earners.[6]

We might like to believe that someone who is already a millionaire doesn’t care about obtaining even more money. But this does not appear to be how actual millionaires behave. Even some billionaires actively attempt to lower their tax rates, for example by relocating to tax havens.

While excessive acquisitiveness (greed) is hardly a virtue, acquisitiveness and ambition might not be bad traits in entrepreneurs. Otherwise Steve Jobs, Sam Walton, and Warren Buffet might have cashed out and retired in Tahiti after making their first $100 million instead of staying on and developing their companies.

While it may offend an egalitarian worldview, top entrepreneurial talent is not easily replaced. “Super-Entrepreneurs” often tend to be extremely talented individuals with access to well-paying, comfortable jobs in already existing firms. In order to entice enough of them to take the risk, hard work, and uncertainty associated with

entrepreneurship instead of opting for a safe and well-paying job, there must be a substantial reward associated with success.

One way to better approximate the behavior of innovative entrepreneurs is to study investments in the Venture Capital (VC) sector. VC plays a central role for high-potential firms. More than half of those entrepreneurial firms that were successful enough to make an IPO and become public had VC backing. Harvard researchers Josh Lerner and Paul Gompers show that VC fundraising in the United States is highly sensitive to capital gains taxes.[7] Their results indicate that the cause for this is that lower capital gains taxes encourage more skilled individuals to become entrepreneurs.

The low probability of entrepreneurial success even for the talented is often forgotten in the tax debate. Sure, Gates and Walton might well still have created Microsoft and Wal-Mart for $25 billion instead of $50 or $100 billion. But for every such success, there are thousands of failures. Entrepreneurship is what economists refer to as a “tournament,” a process where many compete for a prize that only a handful will ultimately receive. If taxes reduce the value of the prize, fewer will enter the tournament, even assuming that the behavior of the winners doesn’t change. Economists William Gentry and Glenn Hubbard found that high marginal taxes reduce the probability that an individual will enter self-employment to begin with (although admittedly the data did not allow them to establish this definitively).[8]

Another common fallacy in the tax debate is that entrepreneurs do not care about taxes because they are motivated by intrinsic factors. Indeed, non-monetary rewards are important for entrepreneurs (although three-quarters self-report that they also care about monetary rewards). But taxes also matter for the ability to build a new company, even disregarding the personal wealth of the entrepreneur.

Profit taxes lower the amount of capital available for reinvestment. The negative effect of corporate income taxes on business investments has been confirmed by numerous studies, such as a recent one conducted by Harvard economist Andrei Shleifer and co-authors.[9]

Furthermore, the growth of new high-potential ventures depends not only on individual entrepreneurs, but also on the ability to attract talented employees. Like entrepreneurs, these workers often have high paying and rewarding jobs, and a career ladder that they must leave if they choose to work for the new company. Few early stage entrepreneurial firms can compete on wages, instead relying on option programs and promises of future reward. Such incentive mechanisms are made more costly by high taxes, which disproportionally target the small probability of great success.

With higher taxes, even entrepreneurs who do not care about personal gains will find it harder to grow through reinvestment, raising external capital, and attracting new talent. In short, even if you don’t care about taxes, taxes care about you.

What to Do about the Tax Code

The United States still leads Western Europe in innovative entrepreneurship. For instance, each year venture capital investments per person are about four to five times higher in the United States than in Western Europe. Is the president willing to risk one of the last sectors in which the United States enjoys a comparative advantage, betting that less burdensome taxes have nothing to do with this competitive edge?

If the tax increases on capitalists proposed by President Obama would balance the budget, perhaps we should endure the damaging effect on economic output. However,

as noted above, the impact on the deficit is symbolic in nature. Rather, the motivation appears to be political, a combination of resentment towards the rich and a reaction to excessively ideological supply-siders.

Currently, less than half of national income is included in the basis for taxable income. Instead of raising tax rates, we can close tax loopholes and broaden the tax base so as to raise revenue to its historic average, while controlling federal spending. This is preferable to increasing tax rates based on the faulty notion that raising taxes on the rich does not hurt economic output.

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***FURTHER READING*: Stephen Moore dissects American tax policy in "Guess Who Really Pays the Taxes." For more on tax reform, see Alan Viard's "The Myth of a Return to Clinton-era Taxes," Veronique de Rugy's "Slay This Tax 'Monster,'" and Aparna Mathur's "Race to the Top of the Laffer Curve."**

Footnotes

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