THE TAXONOMIST

Do Fat Cats Pay Lower Tax Rates than Workers?

By Robert S. McIntyre

When then-presidential candidate John Edwards complained that "something is deeply wrong when a billionaire has a lower tax rate than his secretary," he was talking about George W. Bush's cut in the top tax rate on dividends and capital gains to only 15 percent. But it got me thinking. Even with Bush's huge new loophole, do we really tax *total* personal investment income much more lightly than wages? This April, I spent a few weeks working out the arithmetic.

The short answer is that when Edwards charged that workers pay "at more than twice the rate" of wealthy investors, he understated his case. In fact, these days the average tax rate people pay on earnings is a lot more than double the rate on investment income.

If the income tax treated earned and unearned income by the same rules, then its graduated rates would naturally hit unearned income the hardest. But besides all the various tax shelters for capital gains, dividends, municipal bonds, real estate and so forth, there's the fact that a major portion of investment income is never reported. Together, legal loopholes and cheating cut the average tax rate on unearned income by more than half, down to only 9.6 percent.

Meanwhile, earned income is almost entirely reported on tax returns and on top of that, pays two taxes. First, there's the income tax, which averages 10.7 percent, and second, there's the payroll tax, which averages 12.7 percent. So the total tax on earnings is 23.4 percent—two-and-a-half times the rate on investment income.

Looked at another way, earnings make up 71 percent of total personal income, but taxes on earnings account for 88 percent of total income and employment taxes. In contrast, investment income is 22 percent of total personal income, but accounts for only 11 percent of personal taxes.

President Bush deserves some of the blame for this situation. His new tax breaks for capital gains and dividends, along with his cuts in income tax rates generally, have lowered personal taxes on unearned income by more than a fifth. Bush's tax cuts for earned income, however, are less than a tenth. On top of that disparity, Bush's tolerance for tax shelters and cheating has encouraged even more upper-income tax avoidance and evasion on investment income.

But things have been moving in a Bushian direction for decades. Before Ronald Reagan took office, the top income tax rate on most unearned income was 70 percent, compared to a 50 percent top rate on earnings. The capital gains tax rate, now 15 percent, was 35 percent. And payroll taxes were almost a quarter lower than they are today. Back then, our lawmakers seemed to understand that working is harder than coupon-clipping.

Of course, for radical right-wingers, even our current low taxes on investment earnings remain far too high. Their affection for a "flat tax" is not just its single rate, but even more important, its full exemption for investment income. They hope that if there's a second Bush term, they may get their way.

Those who think otherwise can find some reassurance in John Kerry's call for restoring the pre-Bush top income tax rates and curbing Bush's capital gains and dividends tax breaks. (The latter is a nice reversal, since Kerry had previously called for a dividend tax cut even before Bush proposed it.)

But Kerry also should take a hard look at getting more unearned income reported on tax returns. Right now, for instance, small-time investors see all their capital gains reported to the IRS by their mutual funds. In contrast, big-time investors can pretty much make up their own numbers, and many of them do—which is why total reported capital gains are estimated to be about a quarter below what legally ought to be declared. Stockbrokers have all the information that the IRS needs to enforce the law; they're just not required to report it.

Then there's the big enchilada. Why do we exempt investment income from Social Security and Medicare taxes? Those who fear that an additional 15 percent tax on investors' incomes would be too big a burden need to explain why they don't feel that way when it comes to workers.

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