



WARREN BUFFETT'S CALL FOR HIGHER TAXES ON THE RICH

By Arthur B. Laffer

Summary

- Warren Buffett's public call in the *New York Times* for the government to raise taxes on him and other "mega-rich" citizens is both hypocritical and dangerous.
- It is hypocritical because Buffett consciously shields almost the entirety of his true income from federal income taxation, and he makes clear his belief that he can do more good with his wealth than Uncle Sam.
- The call for higher tax rates is also dangerous because doing so would stifle economic growth and, depending on the severity of the hikes, could actually reduce federal revenue relative to what it otherwise would have been.

Introduction

The political season has barely begun and yet we already know that class warfare will be President Obama's key issue in the 2012 general election. The progressive intelligentsia is obsessed with tax increases on the rich to raise revenues and to achieve social justice.

High profile supporters of the president are joining the class warfare chorus. In an August 2011 *New York Times* op-ed, Warren Buffett asked Congress to "stop coddling the super-rich," complaining that his effective tax rate was half that of the other people in his office.¹ He then instructed Washington to raise tax rates on millionaires and billionaires like him and retain the employee payroll tax cut on those "who need every break they can get."

Waving Buffett's op-ed for all to see, President Obama has proposed a surtax on millionaires, called the "Buffett Rule." Putting aside all the "oohing" and "ahhing" over Buffett's selflessness, his effective tax rate on his true income would hardly budge if this "Buffett Rule" were applied.

What's worse, raising tax rates on the highest income earners would most likely *worsen* the federal budget deficit and lead to a further weakening of the economy, which would penalize everyone across the income distribution.²

This having been written, Buffett is uniquely situated to comment on how he and his "mega-rich" friends could materially affect Federal tax policies. As the richest or second richest American, his words have *gravitas*. If he really felt the way he says he does, then he could have proposed that the "coddled" billionaires who don't "fight for us in Afghanistan" could achieve "shared sacrifice" and significantly reduce the deficit. This, without damaging the economy through a once and for all tax of 50 percent on all wealth over, say, \$1 billion, including, of course, all philanthropic gifts that currently qualify for tax exemptions. But he didn't.

Buffett on Taxes

The following excerpts capture the tone and substance of Buffett's August *New York Times* op-ed:

OUR leaders have asked for "shared sacrifice." But when they did the asking, they spared me. I checked with my mega-rich friends to learn what pain they were expecting. They, too, were left untouched.

While the poor and middle class fight for us in Afghanistan, and while most Americans struggle to make ends meet, we mega-rich continue to get our extraordinary tax breaks. Some of us are investment managers who earn billions from our daily labors but are allowed to classify our income as "carried interest," thereby getting a bargain 15 percent tax rate. Others own stock index futures for 10 minutes and have 60 percent of their gain taxed at 15 percent, as if they'd been long-term investors.

...

¹ Warren Buffett, "Stop Coddling the Super-Rich", *NY Times*, Print version 8/15/2011, page A21, available at: <http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html>.

² Arthur B. Laffer and Ford M. Scudder, "The Onslaught from the Left, Part II: Presidential Politics", Laffer Associates, January 25, 2008.

Last year my federal tax bill—the income tax I paid, as well as payroll taxes paid by me and on my behalf—was \$6,938,744. That sounds like a lot of money. But what I paid was only 17.4 percent of my taxable income—and that's actually a lower percentage than was paid by any of the other 20 people in our office. Their tax burdens ranged from 33 percent to 41 percent and averaged 36 percent.

...

Back in the 1980s and 1990s, tax rates for the rich were far higher, and my percentage rate was in the middle of the pack. According to a theory I sometimes hear, I should have thrown a fit and refused to invest because of the elevated tax rates on capital gains and dividends.

I didn't refuse, nor did others. I have worked with investors for 60 years and I have yet to see anyone—not even when capital gains rates were 39.9 percent in 1976-77—shy away from a sensible investment because of the tax rate on the potential gain. People invest to make money, and potential taxes have never scared them off. And to those who argue that higher rates hurt job creation, I would note that a net of nearly 40 million jobs were added between 1980 and 2000. You know what's happened since then: lower tax rates and far lower job creation.

...

Job one for the 12 [members of the deficit super committee] is to pare down some future promises that even a rich America can't fulfill. Big money must be saved here. The 12 should then turn to the issue of revenues. I would leave rates for 99.7 percent of taxpayers unchanged and continue the current 2-percentage-point reduction in the employee contribution to the payroll tax. This cut helps the poor and the middle class, who need every break they can get.

But for those making more than \$1 million—there were 236,883 such households in 2009—I would raise rates immediately on taxable income in excess of \$1 million, including, of course, dividends and capital gains. And for those who make \$10 million or more—there were 8,274 in 2009—I would suggest an additional increase in rate.

My friends and I have been coddled long enough by a billionaire-friendly Congress. It's time for our government to get serious about shared sacrifice.³

Buffett the Masochist?

Buffett's article makes three claims, either explicit or implied: (1) Buffett's a really swell guy, willing to pony up his own money to help the cause; (2) neither he nor his "mega-rich" friends care about marginal tax rates when making investment decisions; and (3) raising tax rates on millionaires and billionaires will significantly help in solving the federal government's long-term budget woes. As we'll see, every one of these claims is wrong.

First let's tackle the underlying theme of Buffett's article (and his subsequent interviews), in which we are led to believe that the Rich Man from Omaha has been visited by the Ghost of Christmas Future and now realizes that money doesn't bring happiness. Is it really true that Buffett's proposals would result in him paying a higher effective tax rate than, say, the secretaries in his office?

If we just focus on what Buffett wants us to see, the answer seems to be a clear "yes." Buffett states that he paid \$6,938,744 in total income and payroll taxes in 2010, representing 17.4 percent of his taxable income. That means Buffett's taxable income was a hair under \$40 million. If the government followed Buffett's advice and implemented two new tax brackets—one at \$1 million and another at \$10 million—with progressively higher marginal rates, and taxed realized capital gains and dividends at the same rate as wages and salaries (which Buffett seems to endorse, though it's ambiguous), then Buffett would end up owing a much higher tax bill, assuming he didn't alter his behavior. Voilà, here we have a billionaire apparently willing to fall on the sword for the sake of "shared sacrifice."

There are just two problems with this analysis: It grossly understates Buffett's true income (and hence overstates his effective tax rate, with or without his proposals), and it ignores the smoking-gun evidence we have that Buffett shields his income from the government just like the supply-siders claim.

A standard definition of income is the amount of consumption one can finance, without reducing one's wealth. Equivalently, income over a certain period is consumption plus any increment in wealth. Under this definition, paychecks are of course part of income, as are interest earnings on bonds, dividends on stock, and capital gains on any assets, whether or not "realized."

Although Buffett's 2010 taxable income of \$40 million is a fantastic sum, it understates his actual income by more than 250-fold.

³ Buffett, "Stop Coddling the Super-Rich", *NY Times*.

According to the Congressional Budget Office,

Its name notwithstanding, the underlying base of the U.S. income tax system departs significantly from definitions of income. Indeed, a chief difference among many reform proposals is the question of the appropriate tax base. There are two useful benchmarks. One is a tax on comprehensive income (often referred to as a Haig-Simons income tax). Comprehensive income includes all labor compensation earned during the year (regardless of whether it is actually paid or deferred) and all capital income (again, regardless of whether it is realized or not). Comprehensive income measures the additions to an individual's potential to purchase consumption items.⁴

According to *Forbes Magazine*, Buffett's net worth rose by \$10 billion in 2010 to \$47 billion. That increase is an unrealized capital gain, and is part of his total income. As for the past decade, Buffett's net worth rose \$21.4 billion, which means that his average total income averaged more than \$2 billion per year.⁵

Yet, even these figures grossly understate Buffett's 2010 income. Buffett's gift to the Bill and Melinda Gates Foundation was worth \$1.6 billion in 2010. This, too, should be included as part of Buffett's income. And these are just the additions to his income that we know about.

Buffett's true income in 2010 was therefore much closer to \$11.6 billion rather than the \$40 million figure Buffett cites in his op-ed, and hence his true effective tax rate was only 6/100^{ths} of 1 percent as opposed to 17.4 percent. Buffett's proposal to raise taxes on the rich would not tax the vast majority of his shielded income, including either his unrealized capital gains, which are currently taxed at zero percent, or charitable contributions, which are tax deductible. President Obama has proposed a surtax on millionaires, calling it the "Buffett Rule," in order to make their effective tax rate at least as high as middle-income families. Suppose Buffett had paid the same effective rate on his *taxable* income, as the average of his office co-workers (36 percent). Then his federal tax bill would have been \$14.4 million, rather than the \$6.9 million he actually paid. Yet as a fraction of his true income, the "Buffett Rule" would have made his effective tax rate rise from 6/100^{ths} of 1 percent to 12/100^{ths} of 1 percent.

Buffett's donation to the Gates Foundation goes to the very heart of my critique of his public call for higher tax rates on the rich. Here are his three conditions for his ongoing pledge to the foundation (I've switched the order for dramatic suspense):

- (1) Either Bill or Melinda Gates must be alive and actively involved in the management of the foundation.
- (2) Starting in 2008, the total value of the previous year's gift must be spent.
- (3) The foundation must continue to satisfy the legal requirements qualifying Buffett's gift as charitable, exempt from gift or other taxes.⁶

In other words, if his gift weren't tax sheltered he wouldn't give it. So much for "shared sacrifice."

Incidentally, we're not the first to question Buffett's commitment to "shared sacrifice" in balancing the federal budget. In 2007 Rebecca (Becky) Quick of CNBC asked Buffett why he shelters his money through tax-free strategies, rather than writing big checks to Uncle Sam. Here was his answer:

Well, that's a choice and it's an option ... If I had to give it to a single individual, or make some young Buffett a multibillionaire, or give it to the government, I'd absolutely give it to the government. I think that on balance the Gates Foundation, my daughter's foundation, my two sons' foundations will do a better job with lower administrative costs and better selection of beneficiaries than the government.⁷

In other words, Warren Buffett thinks he can do a better job with his money than give it to the government. I guess he's really not so different from the rest of us after all. That's the beauty of keeping *all* tax rates low, and not just those on unrealized capital gains (which are currently taxed at zero percent).

⁴ Douglas Holtz-Eakin, "The Tax Code's Impact on the Reliability of Revenue Projections", CBO Testimony, 7/22/2004, available at: <http://cbo.gov/doc.cfm?index=5675&type=0>.

⁵ See the compilation of the Forbes data at <http://www.guardian.co.uk/news/datablog/2010/mar/11/forbes-rich-list-top-ten-carlos-slim>.

⁶ All information regarding Buffett's gift to the Gates Foundation available at: <http://www.gatesfoundation.org/about/Pages/implementing-warren-buffetts-gift.aspx>.

⁷ "Warren Buffett's Tax Dodge", *WSJ*, 8/17/2011, available at: <http://online.wsj.com/article/SB10001424053111903918104576504650932556900.html>.

Biting the Hand That Feeds You

Buffett also states in his *NYT* op-ed that in his 60 years working with investors he has yet to see anyone “shy away from a sensible investment” ... “even when capital gains rates were 39.9 percent in 1976-77.”⁸ Buffett's choice of 1976-1977 is prescient because the economy in 1977 was a basket case. The official BLS unemployment rate was 7.1 percent, consumer price inflation was 6.7 percent and the S&P 500 dropped 11.5 percent in nominal terms, or a whopping 17 percent after adjusting for inflation. 1977 is a good illustration of the type of economy Buffett's policies would deliver.

The true irony here is that just about *everybody* (except Buffett) recognizes that capital gains are extremely sensitive to the supply-side effects of capital gains tax rates. His mega-rich friends focus on tax rates like laser beams. Realized capital gains tumble when tax rates on them rise and soar when tax rates fall. Just check the numbers.⁹

Buffett continues writing about his investor friends stating that “people invest to make money, and potential taxes have never scared them off.”¹⁰ And to make his point, he compares the 1980 to 2000 period when 40 million jobs were created, to what's happened since 2000 with lower tax rates and fewer jobs created. Surprisingly, Buffett is actually trying to cite the phenomenal growth during the period 1980-2000 as a result of *high* taxes. But of course, the 1980s and 1990s should be used as Exhibit A for why Buffett's proposals are dead wrong. During the period 1980 through 2000, the top marginal income tax rate was slashed from 70 percent to 39.6 percent; the capital gains tax rate was dropped to 20 percent from 39.9 percent in 1977 with capital gains on the sale of homes to virtually zero percent.

And when it comes to raising tax revenues by raising tax rates on the rich, Buffett would again appear to be on the wrong side of the argument.

Setting aside his sincerity, Buffett's proposals would stifle economic growth and, paradoxically, might even reduce tax receipts, depending on the numbers. Despite Buffett's claim to the contrary, of course investors and other high-income earners take tax consequences very seriously when structuring their activities. It might be true that a blue collar, 9-to-5 wage earner punching a clock is largely unresponsive to marginal income tax rates: he's going to go to work at his job, regardless.

Yet when it comes to the “mega-rich,” things are different. The rich can afford armies of tax accountants and lawyers, and can alter the timing, location, and composition of their income. The rich can always shift their investments into tax-advantaged strategies. Since Buffett is a master at playing the game, he knows exactly what we mean.

The empirical record illustrates the supply-side theory quite well. Because tax receipts would naturally grow with the economy with the passage of time, it's no feat to demonstrate that the absolute amount of taxes paid by the rich went up after a reduction in marginal tax rates. Therefore, to stack the deck against us, we'll look at taxes paid as a percentage of GDP. If Buffett were correct, and the rich didn't alter their behavior in light of tax incentives, then we'd expect taxes paid by the rich, as a share of the economy, to fall after an episode of “tax cuts for the rich.” On the other hand, if the supply-siders are right, it's not clear what would happen. The rich would earn and report more income, but would pay lower tax rates. As a result tax revenues could go either way. In short, if the rich ended up paying a higher share of GDP in taxes—especially if it happened in several different historical episodes—then that would be pretty conclusive evidence in favor of the supply-side theory. So what does the record say?

From 1921 through 1928 the top marginal personal income tax rate fell from 73 percent to 25 percent. During this period, tax receipts from the top 1 percent of income earners rose from 0.6 percent of GDP to 1.1 percent of GDP. Under the Kennedy tax cuts from 1960 to 1968, the top income tax rate dropped from 91 percent to 70 percent while tax receipts from the top 1 percent of earners rose from 1.3 percent of GDP to 1.9 percent of GDP. By the way, these periods were two of the biggest booms in U.S. history. Guess which period was the third period of boom?

Since 1978, the top earned income tax rate fell from 50 percent to 35 percent, the top capital gains tax rate fell from 39.9 percent to 15 percent, and the highest dividend tax rate fell from 70 percent to 15 percent. President Clinton virtually eliminated the capital gains tax from the sale of owner-occupied homes and cut government spending as a share of GDP by the largest amount ever. The top 1 percent went from paying taxes of 1.5 percent of GDP in 1978, up to 3.3 percent of GDP in 2007. The bottom 95 percent, on the other hand, saw their tax payments drop from 5.4 percent of GDP in 1978 to 3.2 percent of GDP in 2007.¹¹ Why would Buffett want to reverse these numbers?

⁸ Buffett, “Stop Coddling the Super-Rich”, *NY Times*.

⁹ Arthur B. Laffer and Stephen Moore, “The Onslaught from the Left, Part III: The Capital Gains Tax”, Laffer Associates, February 5, 2008.

¹⁰ Buffett, “Stop Coddling the Super-Rich”, *NY Times*.

¹¹ Tax data from IRS statistics of income (SOI).

Of course, cynics might object to the above evidence on the grounds that it was driven by an explosion of income gains. But that's largely the *point*.

The theory behind the Laffer Curve says that by reducing the penalties on the people most able to generate taxable income, the government will see a large rise in the tax base and, depending on the numbers, may end up collecting more total tax receipts. Now if in practice we see an increase in revenues, *of course* this will occur when the upper brackets have a surge in their incomes. We have to ask the cynics, what exactly is your goal? You have been saying you want to raise tax rates on the rich to close the budget deficit. Is that really the objective, or instead is it to simply punish people who are making an "unfair" amount of money?

Conclusion

Buffett's public call for the government to raise taxes on him and other "mega-rich" citizens is both hypocritical and dangerous. It is hypocritical because Buffett consciously shields almost the entirety of his true income from federal income taxation, and makes no bones about his belief that he can do more good with his wealth than Uncle Sam. Buffett's call for higher tax rates is dangerous because doing so would stifle economic growth and, depending on the severity of the hikes, could actually reduce federal revenue relative to what it otherwise would have been.

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