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Letter from America: Tax Cuts, Income Distribution and Fairness in the United States

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Experiments by behavioral economists and psychologists have shown the remarkable extent to which people's perceptions of what if fair are conditioned by their own self-interests. Asked to split the wages for a job between themselves and a coworker, they define "fairness" as reward proportional to effort when they themselves have contributed more effort, but as an equal division of the total when they themselves have contributed less. Even when provided with incentives to come to the same conclusions as an unbiased judge, people find the same arguments more convincing when they serve their own self-interest, even when that self-interest has been randomly defined by the experiment. Most remarkable of all is the effect of educating people about this largely unconscious bias; education reinforces their beliefs that others are biased, but does nothing to eliminate their own biases.

It is hard to imagine that anyone would defend the tax policies of the current American administration as fair, although there has been a good, if unusually unconvincing, roll out of the familiar arguments about incentives and growth. The redistributive effects of the most recent round of current tax cuts are huge. According to the estimates of the Center for Tax Justice, an organization that is funded by unions to lobby against tax cuts for the wealthy and for well-heeled special interests, but whose numbers are usually reliable, two-thirds of the benefits of the tax-cuts will go to the top ten percent of taxpayers, and fully a half to the top five percent. Over the next four years, someone in the top one percent of the income distribution will pay almost $100,000 less in taxes than if this year's changes had not been legislated. The corresponding figure for the average person in the bottom 20 percent is $36. As the legislation behind these numbers was being debated earlier this summer, the Internal Revenue Service, at the suggestion of Joel Slemrod of the University of Michigan, published data on the top 400 income tax returns for the eight years from 1992 to 2000, all filed before the latest rounds of tax cuts. The mean income of this group rose from $46.8 million in 1992 to $174 million in 2000-I am talking about annual incomes here, not wealth, and indeed incomes that exclude many kinds of non-taxable incomes and tax shelters that are important for many of the rich-and the cutoff for membership of the 400 club rose from $22.8 million in 1992 to $65.9 million in 2000. The average tax rate among the top 400 fell from 26.4 percent in 1992 to 22.3 percent in 2000, about the same average rate as a straightforward application of the tax code would generate for someone earning $123,000, less than a thousandth of the mean in the top 400.

Jeff Sachs, in a splendid op-ed piece in the New York Times, noted that if each of the top 400 were to donate their share of the Bush tax cuts, there would be enough to fund $7 of the $8 billion annual US share of the cost of what Sachs and the WHO believe is necessary to pay for minimally adequate healthcare of the world's poor, and thus to stimulate the economic growth that will permanently remove them from poverty.

One of the leading proponents of tax-cuts is Representative Bill Thomas, Republican of California, who is Chairman of the House Ways and Means Committee, inevitably (and correctly) referred to as the "powerful" House Ways and Means Committee. Thomas, who is an able and widely feared chairman, has been in the news recently over an only apparently arcane piece of legislation involving the rules affecting how much of corporate profits must be diverted to fund the prospective liabilities of defined-benefit pensions for their employees. These rules have a direct effect on the effective ownership of many large corporations, with the employees on the one side, and the executives and shareholders on the other. Outraged by not being consulted over midnight changes in the draft legislation, the Democratic members of the Committee walked out en masse, whereupon Chairman Thomas sent the police to break up their meeting, an act for which he later apologized to his colleagues. But he has been making no apology for the tax cuts or for their redistributive effects. He likes to draw attention to the fact that 96 percent of total taxes are paid by only a half of individuals, a fact that seems unfair to many Americans. Thomas' colleague, Leader of the House Dennis Hastert, described the House's recent vote to abolish the estate tax as about "fairness to families." The recent tax cuts were sweetened by a temporary (two-year) tax credit for children, and over the summer, cheques were mailed out to families amidst much presidential publicity and fanfare. Yet even here, right-wing Republicans, who believe in helping people only to the extent that they pay taxes, blocked attempts to extend the payments to all children. As a result, many poor families with children received no money, in some cases much to their surprise and consternation, because they had not paid enough taxes to qualify. Apparently, it is not money that children need, but tax relief.

The argument that fairness should be thought of, not in terms of post-tax incomes or wealth, but in terms of the amount of taxes paid, appears to have a wide appeal, not just among wealthy Republican voters, but among many middle-class American taxpayers. The New York Times, one of America's most steadfastly liberal newspapers, describing the findings on the 400 highest incomes, noted that the top 400 earned 1.1 percent of total income, but paid a "disproportionate" 1.6 percent of total taxes, and concluded that this was "evidence that all sides in the current tax debate will be able to find ammunition in these data." As indeed they have. But so far, the Republicans have been easy winners, abandoning the traditional argument that tax cuts, even if unfair, are needed on efficiency grounds, for the new and much more attractive argument that tax cuts are not only good for the economy, but are also fair. That such policies can be supported in a democracy where the majority of people do not benefit from them speaks eloquently to the power of money in American politics, as well as to the extent that widening income inequality, especially at the very top, has made it possible for the Republican party to successfully position itself as the party of the rich.

Angus Deaton's Letter from America appears every six months in the Royal Economic Society's Newsletter. For more information, visit http://www.res.org.uk/society/newsletters.asp.

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