



# THE BUFFETT RULE: A BASIC PRINCIPLE OF TAX FAIRNESS

The National Economic Council

April 2012



**EMBARGOED FOR 6:00 AM TUESDAY APRIL 10, 2012**

## The Buffett Rule: A Basic Principle of Tax Fairness

The Buffett Rule is the basic principle that no household making over \$1 million annually should pay a smaller share of their income in taxes than middle-class families pay. Warren Buffett has famously stated that he pays a lower tax rate than his secretary, but as this report documents this situation is not uncommon. This situation is the result of decades of the tax system being tilted in favor of high-income households at the expense of the middle class. Not only is this unfair, it can also be economically inefficient by providing opportunities for tax planning and distorting decisions. The President has proposed the Buffett Rule as a basic rule of tax fairness that should be met in tax reform. To achieve this principle, the President has proposed that no millionaire pay less than 30 percent of their income in taxes.

### Why the Buffett Rule Is Needed

- ❖ **The average tax rate paid by the very highest-income Americans has fallen to nearly the lowest rate in over 50 years.** The wealthiest 1-in-1,000 taxpayers pay barely a quarter of their income in Federal income and payroll taxes today—half of what they would have contributed in 1960. And, the top 400 richest Americans—all making over \$110 million—paid only 18 percent of their income in income taxes in 2008.
- ❖ **Average tax rates for the highest income Americans have plummeted even as their incomes have skyrocketed.** Since 1979 the average after-tax income of the very wealthiest Americans – the top 1 percent – has risen *nearly four-fold*. Over the same period, the middle sixty percent of Americans saw their incomes rise just 40 percent. The typical CEO who used to earn about 30 times more than his or her worker now earns 110 times more.
- ❖ **Some of the richest Americans pay extraordinarily low tax rates—as they hire lawyers and accountants to take particular advantage of loopholes and tax expenditures.** The *average* tax rate masks the fact that some high-income Americans pay near their statutory tax rate, while others take advantage of tax expenditures and loopholes to pay extraordinarily low rates—and it is these high-income taxpayers that the Buffett rule is meant to address .
  - Of millionaires in 2009, a full 22,000 households making more than \$1 million annually paid less than 15 percent of their income in income taxes — and *1,470 managed to paid no federal income taxes on their million-plus-dollar incomes*, according to IRS data.
  - Of the 400 highest income Americans, one out of every three in this group of the most financially fortunate Americans paid less than 15 percent of their income in income taxes in 2008.
- ❖ **Many high-income Americans are paying less in taxes than middle class Americans in taxes.** Nearly one-quarter of all millionaires (about 55,000 taxpayers) face a tax rate that is lower than more than millions of middle-income taxpayers. This is fundamentally unfair.

In his State of the Union address, President Obama called for comprehensive tax reform that cuts rates, cuts inefficient tax loopholes, cuts the deficit, increases job creation and growth, and sets out a very simple principle of fairness: No household making over \$1 million annually should pay a smaller share of income in taxes than middle-class families pay. To achieve this, the President has proposed that no millionaire pay less than 30 percent of their income in taxes.

This is the “Buffett Rule.” As Warren Buffett has pointed out, his effective tax rate is lower than his secretary’s—and that is wrong. To be clear, there is tremendous variation in tax rates for high-income households, with many, like small business owners who receive primarily labor income and take advantage of few special tax benefits, paying taxes at an effective rate not dramatically lower than their statutory rate. But as a recent analysis by the Congressional Research Service concluded, “the current U.S. tax system violates the Buffett rule in that a large proportion of millionaires pay a smaller percentage of their income in taxes than a significant proportion of moderate-income taxpayers.”

This basic source of unfairness is what this principle would address, by limiting the degree to which the most well-off can take advantage of tax expenditures and preferential rates on certain income. In a time when all Americans are being asked to come together to make the sort of shared sacrifices that will allow our country to continue making the crucial investments that are necessary to grow our economy, continuing to allow some of the wealthiest Americans to use special tax breaks to avoid paying their fair share simply cannot be justified. Moreover, addressing these inequities through tax reform that includes a Buffett Rule can also improve the efficiency of the tax system by discouraging tax planning and reducing distortions to behavior.

## **I. The Average Tax Rate Paid by the Very Wealthiest Americans Has Fallen to Nearly Its Lowest level in Over 50 Years**

For the very wealthiest Americans, the amount of taxes they have paid on average has fallen sharply over recent decades.

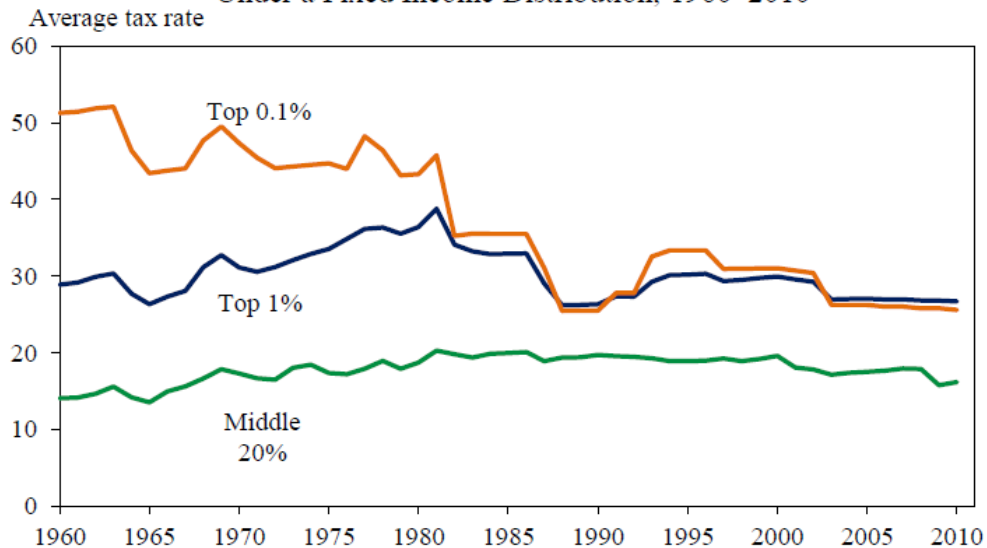
- Among the top 0.1 percent — the highest-income one out of every thousand American households — the average tax rate, including Federal income and payroll taxes, has dropped *a stunning 50 percent over the last 50 years*, from 51 percent to 26 percent (see Figure 1). This is nearly the lowest rate in over 50 years and is, in fact, one-half the rate they would have paid in 1960.
- To take even a thinner slice the 400 highest-income households, all of whom made over \$110 million in 2008, the most recent year for which data are available, for an average of \$271 million — paid just 18.1 percent of their incomes in Federal income (excluding payroll) tax on average, according to the IRS. In 2007, it was just 16.6 percent. This is nearly half the 29.9 percent rate those households paid on average in 1995.

- In contrast, the middle class have seen their taxes roughly constant, or slightly increasing, over this period. The middle quintile, for example, paid 14 percent of its income in taxes in 1960 and 16 percent in 2010.
- Part of this remarkable trend is a result of the 2001 and 2003 tax cuts for the highest income Americans that were unfair and unaffordable at the time they were enacted and remain so today. Between 2000 and 2008, income tax rates for the top 0.1 percent fell by 4.7 percentage points.

Figure 1 shows the trend in average tax rates since 1960 for top- and middle-income earners. Importantly, these estimates calculate effective tax rates in each of these years based on the actual income distribution in 2005, with their incomes adjusted for the national average wage growth each year before and after. This effectively controls for changes in the distribution of income so as to give a clear reading of what happened purely as a result of changes in tax policy. In contrast, other estimates also show that the tax system has become substantially less progressive but understate the magnitude of this change because they cover the same period that the highest income Americans were earning more relative to others.

**Figure 1**

**Average Tax Rates for Selected Income Groups  
Under a Fixed Income Distribution, 1960–2010**



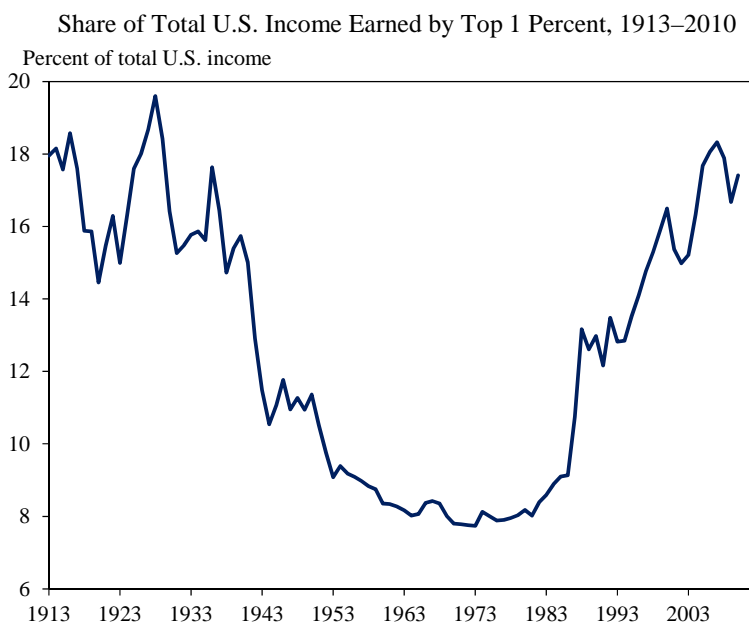
Note: Average Federal (income plus Federal Insurance Contributions Act) tax rates for a sample of 2005 taxpayers after adjusting for growth in the National Average Wage Index. Source: Internal Revenue System Statistics of Income 2005 Public Use File, National Bureau of Economic Research TAXSIM, and CEA calculations.

## II. Average Tax Rates for the Highest Income Americans Have Plummeted Even As Their Incomes Have Skyrocketed

Over the past four decades, income inequality has risen dramatically, severing the link that previously existed between economic growth and middle class standards of living. By the time the financial crisis struck, these trends had resulted in the wealthiest Americans receiving a greater share of the country's total pre-tax income than at any time since the Roaring Twenties.

- While the economic growth that followed the end of World War II was broadly shared by Americans of all income levels, the income gap has increased dramatically in the past four decades.
- Since 1979, the average after-tax income of the highest income Americans – the top 1 percent – has risen nearly four-fold. Over the same period, the middle sixty percent of Americans saw their incomes rise just 40 percent. The typical CEO who used to earn about 30 times more than his or her workers now earns 110 times more.
- The wealthiest one of every hundred households — the top 1 percent — now take home 17 percent of the total income earned by all American workers (see Figure 2), among the very highest shares of any time since the 1920s.
- This rising economic inequality has meant that the very rich have received, over the years, an outsize share of the country's economic growth. The typical American family — whose real income actually has fallen over the past decade by about 6 percent on average — has been left far behind.

Figure 2



Note: Total income includes wages and salaries (including bonuses and stock-option exercises), pensions, profits, farm income, dividends, interest, and rental income.  
Source: Piketty and Saez (2003, 2010)

### III. Some of the Richest Americans Pay Extraordinarily Low Tax Rates

The *average* tax rate masks the fact that some high-income Americans pay near their statutory tax rate, while others take advantage of tax expenditures and loopholes to pay almost nothing. For example, a hedge-fund manager might characterize his or her compensation as capital gains, thereby paying a fraction of the taxes they would pay if their income was classified as wages, the same as other working Americans. It is these high-income taxpayers that the Buffett rule targets. The Buffett Rule is not an across-the-board tax increase on high-income households; it is a way to ensure that no millionaire is paying less than the middle class.

- Of those making over \$1 million in 2009, fully 160,000 households paid less than 30 percent of their income in direct income and payroll taxes in 2009, according to an analysis of the IRS’s 2009 Statistics of Income file by the Treasury Department’s Office of Tax Analysis. (Note that that number is projected to be lower in 2013 when the temporary tax rates on high-income households are scheduled to expire.)
- Of these millionaires, over 22,000 families paid less than 15 percent of income in Federal income and employee payroll taxes — and 1,470 managed to paid *no federal income taxes* on their million-plus-dollar incomes, according to the IRS.
- The distribution of taxes paid among the 400 richest Americans is particularly striking. One out of every three in this group of the most financially fortunate Americans paid less than 15 percent of their income in taxes in 2008 (see Table 1). And 85 percent of the 400 highest income households paid an effective rate of less than 30 percent.

Table 1

Percent of the 400 Highest Income Americans Paying Less Than a Given Effective Federal Income Tax Rate in 2008						
	<i>Under 10%</i>	<i>Under 15%</i>	<i>Under 20%</i>	<i>Under 25%</i>	<i>Under 30%</i>	<i>Under 35%</i>
Percent of top 400	8%	33%	61%	74%	85%	100%

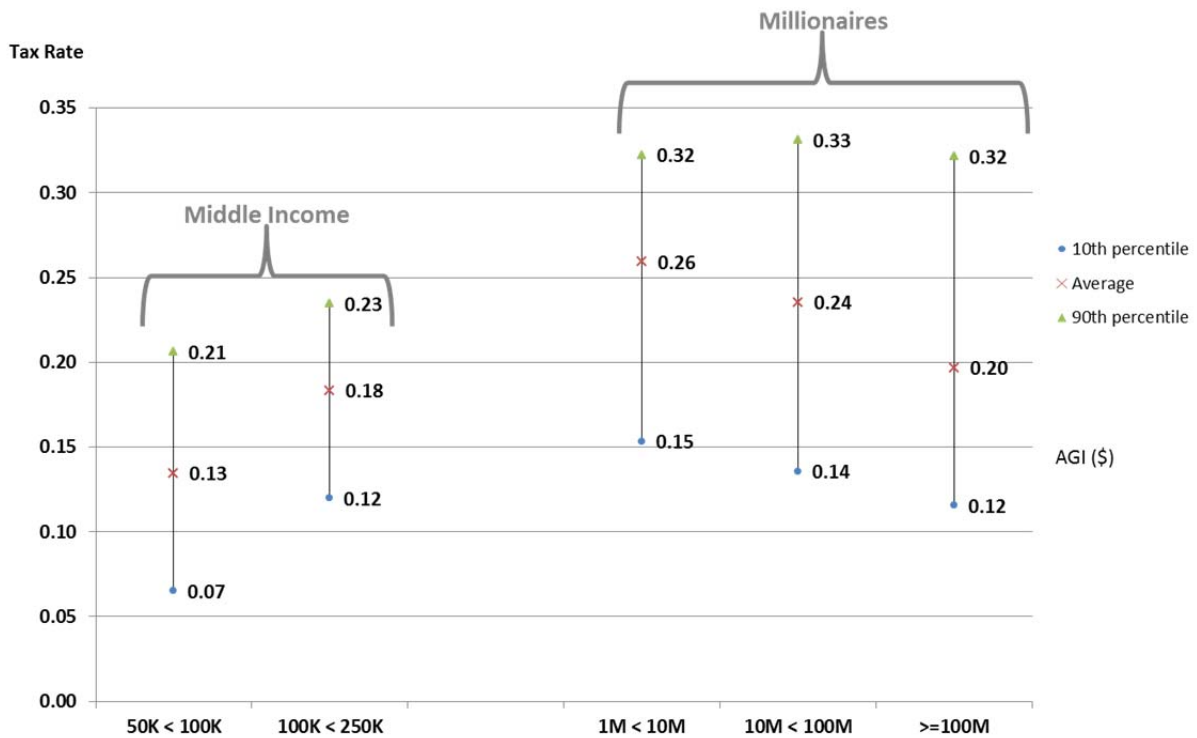
### IV. Many High-Income Americans Are Paying Less As a Share of Their Income Than Middle Class Americans

Because some of the richest Americans pay taxes at such extraordinarily low rates, they end up paying less in taxes as a share of their income in taxes than middle-class Americans. To be clear—on average, high income Americans do pay more. That is because the United States has a progressive tax system in which tax rates generally rise with income, albeit not as much as they have in the past.

However, these average trends mask the substantial variation in tax rates, which is even greater for very high-income households. Some of the wealthiest Americans can hire lawyers and accountants to take advantage of tax expenditures and loopholes that enable them to pay a lower share of their income in taxes than average Americans. In particular:

- Nearly one-quarter of millionaires pay less in taxes than millions of middle-class families:
  - Twenty-four percent of all millionaires (about 55,000 taxpayers) face a tax rate that is lower than the tax rate faced by nearly 1.5 million taxpayers making between \$100,000 and \$250,000 (the 90<sup>th</sup> percentile for this group).
  - Twenty-one percent of millionaires (about 50,000 taxpayers) face a tax rate that is lower than the tax rate faced by 3 million taxpayers making between \$50,000 and \$100,000 (the 90<sup>th</sup> percentile for this group).
- This is illustrated in Figure 3 which shows the distribution of effective tax rates by income class. This figure shows that, while average rates generally rise with income, a significant portion of the highest income Americans pay less in taxes as a share of their income than middle-class families. The figure also shows that the highest income Americans have much more variable tax rates than middle-class families.

**Figure 3**  
**Distribution of Average Tax Rates**  
 (Individual Income Tax and Employee Payroll Tax)



Source: 2009 Statistics of Income Individual Income Tax File.

Note: Average tax rates are calculated as individual income tax plus the employee share of payroll taxes divided by Adjusted Gross Income (AGI).

## V. The Economic Argument for the Buffett Rule

Economic research has shown that taxes are more efficient (or less distortionary) when taxpayers have fewer opportunities to avoid them. The Buffett Rule would reduce these opportunities for the highest income Americans, limiting the extent to which they can take advantage of inefficient tax shelters or accounting mechanisms to avoid paying taxes.

- In a recent paper, Nobel-prize winning economist Peter Diamond and renowned tax economist Emmanuel Saez note the relatively greater ability of high income taxpayers to avoid taxes, and argue that “the natural policy response should be to close tax avoidance opportunities” (*Journal of Economic Perspectives*, Fall 2011).
- Research by economist Wojciech Kopczuk has demonstrated that “base broadening reduces the marginal efficiency cost of taxation” (*Journal of Public Economics*, 2005). Kopczuk also found that the Tax Reform Act of 1986, which broadened the tax base and closed tax loopholes, limited the extent to which high-income taxpayers acted to avoid taxes.
- High-income taxpayers have been shown to avoid taxes by changing the timing of income received. For example, Goolsbee (*Journal of Political Economy*, 2000) found that the primary response by executives to the 1993 tax increase was to change the timing of their stock options. A permanent Buffett Rule would limit these opportunities for tax avoidance, which would enhance economic efficiency.
- Many tax subsidies are designed to support important goals, many with broader economic benefits, like encouraging and supporting homeownership, retirement savings, and health coverage for the middle class. But these subsidies are often upside down, with the largest incentives going to the highest-income households that often have the least need for them. This not only costs money, it can encourage the perception or reality of unfairness, and is economically inefficient.