



BLEEDING OUR GOVERNMENT TO DEATH

Some tax facts hardly anyone knows BY DAVID CAY JOHNSTON

David Cay Johnston is a columnist for *tax.com* and teaches the tax, property and regulatory law of the ancient world at Syracuse University College of Law and Whitman School of Management. He has also been called the “*de facto* chief tax enforcement officer of the U.S.” because his reporting in *The New York Times* shut down many tax dodges and schemes, just two of them valued by Congress at \$260 billion.

Johnston received a 2001 Pulitzer Prize for exposing tax loopholes and inequities. He wrote two bestsellers on taxes, *Perfectly Legal* and *Free Lunch*. Later this year Johnston will be out with a new book, *The Fine Print*, revealing how big business, with help from politicians, abuses plain English to rob you blind.

For three decades we have conducted a massive economic experiment, testing a theory known as supply-side economics. The theory goes like this: Lower tax rates will encourage more investment, which in turn will mean more jobs and greater prosperity — so much so that tax revenues will go up, despite lower rates. The late Milton Friedman, the libertarian economist who wanted to shut down public parks because he considered them socialism, promoted this strategy. Ronald Reagan embraced Friedman’s ideas and made them into policy when he was elected president in 1980.

For the past decade, we have doubled down on this theory of supply-side economics with the tax cuts sponsored by President George W. Bush in 2001 and 2003, which President Obama has agreed to continue for two years.

You would think that whether or not this grand experiment worked would be settled after three decades. You would think the practitioners of the dismal science of economics would look at their demand curves and the data on incomes and taxes and pronounce a verdict, the way Galileo and Copernicus did when they showed that geocentrism was a fantasy because Earth revolves around the sun (known as heliocentrism). But economics is not like that. It is not like physics with its laws and arithmetic with its absolute values.

Tax policy is something the Framers left to politics. And in politics, the facts often matter less than who has the biggest bullhorn.

The *Mad Men* who once ran campaigns featuring doctors extolling the health benefits of smoking are now busy marketing the dogma that tax cuts mean broad prosperity, no matter what the facts show.

As millions of Americans prepare to file their annual taxes, they do so in an environment of media-perpetuated tax myths. Here are a few points about taxes and the

economy that you may not know, to consider as you prepare to file your taxes before April 18 this year. (All figures are inflation adjusted.)

1. Poor Americans do pay taxes.

Gretchen Carlson, the Fox News host, said last year “47 percent of Americans don’t pay any taxes.” John McCain and Sarah Palin both said similar things during the 2008 campaign about the bottom half of Americans.

Ari Fleischer, the former Bush White House spokesman, once said “50 percent of the country gets benefits without paying for them.”

Actually, they pay lots of taxes — just not lots of federal income taxes.

Data from the Tax Foundation shows that in 2008, the average income for the bottom half of taxpayers was \$15,300.

This year the first \$9,350 of income is exempt from taxes for singles and \$18,700 for married couples, just slightly more than in 2008. That means millions of the poor do not make enough to owe income taxes. But they still pay plenty of other taxes, including federal payroll taxes. Between gas taxes, sales taxes, utility taxes and other taxes, no one lives tax-free in America.

When it comes to state and local taxes, the poor bear a heavier burden than the rich in every state except Vermont, the Institute on Taxation and Economic Policy calculated from official data. In Alabama, for example, the burden on the poor is more than twice that of the top 1 percent. The one-fifth of Alabama families making less than \$13,000 pay almost 11 percent of their income in state and local taxes, compared with less than 4 percent for those who make \$229,000 or more.

2. The wealthiest Americans don’t carry the burden.

This is one of those oft-used canards. Sen. Rand Paul, the Tea Party favorite from Kentucky, told David Letterman recently that “the wealthy do pay most of the taxes in this country.” The internet is awash with statements that the top 1 percent pays, depending on the year, 38 to more than 40 percent of taxes.

It’s true that the top 1 percent of wage earners paid 38 percent of the federal income taxes in 2008 (the most recent year for which data is available). But people forget that the income tax is less than half of federal taxes and only one-fifth of taxes at all levels of government.

Social Security, Medicare and unemployment insurance taxes (known as payroll taxes) are paid mostly by the bottom 90 percent of wage earners. That’s because, once you reach \$106,800 of income, you pay no more for Social Security, though the much smaller Medicare tax applies to all wages. Warren Buffett pays the exact same amount of

Social Security taxes as someone who earns \$106,800.

3. In fact, the wealthy are paying less taxes.

The IRS issues an annual report on the 400 highest income taxpayers. In 1961, there were 398 taxpayers who made \$1 million or more, so I compared their income tax burdens from that year to 2007.

Despite skyrocketing incomes, the federal tax burden on the richest 400 has been slashed, thanks to a variety of loopholes, allowable deductions and other tools. The actual share of their income paid in taxes, according to the IRS, is 16.6 percent. Adding payroll taxes barely nudges that number.

Compare that to the vast majority of Americans, whose share of their income going to federal taxes increased from 13.1 percent in 1961 to 22.5 percent in 2007. (By the way, during seven of the eight Bush years, the IRS report on the top 400 taxpayers was labeled a state secret, a policy that the Obama overturned almost instantly after his inauguration.)

4. Many of the very richest pay no current income taxes at all.

John Paulson, the most successful hedge fund manager of all, bet against the mortgage market one year and then bet with Glenn Beck in the gold market the next. Paulson made himself \$9 billion in fees in just two years. His current tax bill on that \$9 billion? Zero. Congress lets hedge fund managers earn all they can now and pay their taxes years from now.

In 2007, Congress debated whether hedge fund managers should pay the top tax rate that applies to wages, bonuses and other compensation for their labors, which is 35 percent. That tax rate starts at about \$300,000 of taxable income; not even pocket change to Paulson, but almost 12 years of gross pay to the median-wage worker.

The Republicans and a key Democrat, Senator Charles Schumer of New York, fought to keep the tax rate on hedge fund managers at 15 percent, arguing that the profits from hedge funds should be considered capital gains, not ordinary income, which got a lot of attention in the news.

What the news media missed is that hedge fund managers don’t even pay 15 percent. At least not currently. So long as they leave their money, known as “carried interest,” in the hedge fund, their taxes are deferred. They only pay taxes when they cash out, which could be decades from now for younger managers. How do these hedge fund managers get money in the meantime? By borrowing against the carried interest, often at absurdly low rates — currently about 2 percent.

Lots of other people live tax-free, too. I have Donald Trump’s tax records for four years early in his career. He paid no taxes for two of those years. Big real-estate