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Tax Breaks for Rich People

This essay is not about all the tax advantages used by rich people. This essay focuses on why rich people get “tax breaks” as in the “Bush Tax Cuts” of the 2000s. The Bush Cuts are one of many advantages held by rich people. These, and other, advantages let rich people pay a smaller rate of their total income in taxes than poor people or middle class people (working poor pay the highest rate, then “blue collar” and “pink collar” working middle class people, then other middle class people). To gain from this essay, you should read my essay about economic growth, or should know about simple growth models that depend on state tinkering in savings and investment, and why they are wrong.

I dislike giving tax breaks to rich people. The policy is morally wrong and causes more harm than good. We should tax as once-upon-a-time we intended to tax; but we should do it better and without breaks for rich people: (1) No tax should be levied below a certain income. (2) Then we should have a short range of incomes for adjusting from no tax to some tax. (3) Then everybody should be taxed roughly at the same rate but with (4) a small graduation so poor people pay a slightly lower rate, middle people pay a middle rate, and rich people pay the highest rate. If we can’t agree on the graduation, then (5) we can use a flat rate for everybody above the proper threshold. The present tax code tries to do this but does it badly because of all the loopholes, breaks, programs, dodges, and shelters. None of those can be allowed. The total tax rate (burden) on poor people can never exceed the total tax rate on middle class people, which rate can never exceed the rate on rich people. The total tax rate includes non-obvious taxes such as a sales tax. The vast majority of state income should be based on income. The scheme I just proposed is simple to see and to put in practice.

This whole issue is complicated by a problem that is usually called “tax on capital gains”. I explain what that is later. This essay avoids the issue of capital gains tax to focus on other issues.

Briefly, people who argue for tax breaks for the rich rest their argument on the following points, even if they don’t make the points explicit, and even if they don’t even know the points. All the points are more WRONG than right for the purposes of this essay. When a point has some merit that we need to look at here, I make that clear in the list and then explain more, in the list or below.

-Some growth is good (true).

-All growth is good (false).

-Most growth is good in the long run (only if it is done "naturally" by investors without distortion caused by market peculiarities and government policy).

-Growth by itself can automatically solve all our problems such as unemployment and bad jobs. We don't need to work on the problems directly. "A rising tide floats all boats; a bigger pie automatically has big enough slices for everyone." (False; see other essays).

-All investment leads to good growth (false).

-All savings lead to good investment (false) that leads to good growth (false).

-When rich people have more money left over after taxes, they save more (mostly true), then investors try to invest their savings (mostly true).

-Almost all the savings of rich people goes to good investment (false) which automatically goes to good investment (false) which automatically goes to good growth (false) which automatically solves all our problems (false).

-So, to make the country grow and solve all our problems, tax rich people only very little so they save and investors use the investment for good growth (all mostly false).

In fact:

-When the economy has found its own "natural" balance of savings for investment for good growth, it does not need, and cannot use, further savings for further investment brought about by state policy.

-Above the natural amount of savings for natural growth, further savings leads to bad investment within the country.

-Above the natural amount of savings for natural growth, further savings leads to investment outside the country; that is, forced savings for investment moves money outside America to other countries.

-Some government programs, such as electrification, are good ways to make good growth. But they are not the same as tax breaks for the rich. See other essays.

More detail on the thinking behind tax breaks for rich people:

Think about a person (or family) who makes (A) $20,000 per year; (B) $40,000 per year; (C) $100,000 per year; and (D) $300,000 per year. How much of each income is spent on all items including necessities such as food and rend; fun stuff such movies and short vacations; luxuries such as a trip to France; and how much is saved? The following is all guess not based on facts.

(A) Spends almost everything on necessities, nothing on anything else, and saves almost nothing.

(B) Spends about half on necessities, the rest on fun stuff, saves maybe 5%, and spends some on luxuries when enough reserves have been built up.

(C) Spends about a quarter on necessities, spends a quarter on fun stuff, saves about 45%, and spends some on luxuries when enough reserves have been built up.

(D) Spends less than 10% on necessities, 10% on fun stuff, 10% on luxuries, and saves 70%.

We do not tax the part of income of anybody used for necessities. Suppose we tax the income of all the people over what they spend on necessities. We tax them all at the same rate. Then we take nothing away from savings from (A) because (A) does not save, little away from savings from (B), a fair amount away from savings from (C), and a huge amount away from savings from (D).

Suppose we really believe the theory described above, so we believe that more savings makes more investment makes more growth makes a bigger pie and solves all our problems. Is there anything we can do through our tax system to increase the amount of savings? Yes. We can drastically lower the tax rate for people in categories (C) and (D), for upper middle class people and rich people.

To make this lower rate for rich people more acceptable to everybody, we can start taxing everybody not beginning at the level that people normally spend on necessities but at double that level. Instead of starting to tax people at $15,000 dollars we can start taxing them at $30,000 (we allow a high standard deduction and allow high exemptions for self and dependants). This way, (A) and (B) feel as if they have enough to live on and to enjoy life a little bit. We get the benefits of a lot of savings for investment for growth automatically.

Because rich people have so much income left over after necessities, that income is available for savings for investment if we DON'T take it away in taxes. If we really want to do what is best for everybody by stimulating growth, then we should not tax rich people much, or hardly at all. We should leave them as much of their income (wealth) as we can so they will save it so it will be used for investment.

People dislike this line of reasoning because they think that rich people use their income just as do poor people and working-middle-class people, or they waste their income. They buy yachts or horses for fun. They buy paintings for investment. They do not invest in productive capacity for the economy as a whole. As a matter of fact, most rich people don't use up their income. Most rich people do invest in productive capacity for the economy as a whole when there are good investments available for good growth. Rich people are not inherently the enemy of the country or of poor people. It depends on the context that we build for them to be rich in.

If you believe all the points of the theory above, then this reasoning is valid. We should give rich people a lot of money to save so investors have to invest, and the economy will grow and benefit as a result. We can do that by not taxing rich people much, not even on income above necessities and above stuff that everybody uses to enjoy life. Rich people don't indulge anyhow, so let them use their income to make savings to make investment to help everybody.

If you don't believe the theory above, then you don't find this reasoning valid. I don't believe the story above. Also, I find the results of programs based on this logic have failed, and so the ideas have been experimentally disproven regardless of the logic.

We don't have to make sure that rich people have more money so the economy has enough savings so it has enough investment so it can grow in good ways. The economy would have enough savings for investment for good growth even if we taxed rich people more than indicated in packages such as the Bush Tax Cuts. America has enough wealth, and enough liquid wealth, so that it can get all the money it needs for investment in good growth from regular savings. America has enough wealth so it can get what it needs if everybody were taxed at a similar rate. We should rely on the natural free market operation of the economy to provide what funds the economy needs for investment.

When we interfere with the natural free market operation of the economy, we give people more to save and to invest than they would have had otherwise. Almost by definition of the natural outcome of a free market, people cannot invest in good growth. Instead, they invest this money in bad growth such as strip malls, shoddy apartment complexes, cutting forest, and strip mines. They don't even invest the money in America but invest it overseas. When we interfere in the natural free market economy, we take money away from poor people, working people, and middle class people to give to rich people so they can give it to overseas investments.

As a matter of empirical fact, the trick doesn't work. I know of no proven case where tax cuts for the rich have resulted in an expansion of the economy that warranted the tax cuts. To argue this point requires data and statistics, and I can't do that here. I challenge readers to prove me wrong.

Here we need a fact. I know of no case (one possible unlikely exception in the Kennedy years) where the state taxed rich people less, the economy expanded as a result of taxing rich people less, and the state made more tax money from the expanded economy than it lost from the taxes of rich people. Business people and economists sometimes say this happens but it does not. I challenge readers to prove me wrong by finding a case where this certainly happened.

The Bush Tax Cuts of the early 2000s did not work. That is a matter of empirical fact. They did not stave off recession and they did not stimulate the economy. They put the country more into debt for no good outcome. At the time of the cuts, America was trying to get over a recession, and, a few years after the cuts, about 2006, America slid into a deep recession and a crisis brought about by very bad management of the housing markets. If anything helped stave off recession after 2001, it was the huge deficit (debt) spending of the Bush Administration to fund wars in Iraq and Afghanistan. Those wars were not funded rationally by a plan with sound revenue, debt, and spending points but simply by massive debt – well over a trillion dollars – it is hard to get the exact number. I challenge readers to make a solid case that the Bush Cuts have done any real good by stimulating the economy and-or keeping us out of recession apart from the spending that also happened in that time. They did only harm by worsening the debt, worsening bad spending on housing, and sending money overseas ("outsourcing").

The famous slogan "there is no free lunch" applies. The state needs a certain amount of money to run. If the state does not get the money from one place, it must get it from another. When the state gets less from one place, it must get more from another. There are slight "fudges" to this rule but they are not relevant here. If the state decides to tax apple farmers less, it has to tax cherry farmers more. It the state taxes hog farmers less, it has to tax beef ranchers more. If the state taxes cars less, it has to tax trucks more. If the state taxes rich people less, it has to tax poor people, working people, and other middle class people more to make up for the lost revenue. Even if the state goes into debt , in the end somebody has to pay the debt, and that will be the people who pay taxes: poor, working, and other middle class.

Increased taxes on poor people, working people, and other middle class people mean that those people buy less, and the economy shrinks. It is not hard to argue that the economy shrinks more from taking money from other people than it grows (if any) from giving rich people more income to keep. It is not hard to argue the economy expands more from letting other people keep and use their income that it does from letting rich people save more of their income. Whether the economy shrinks more, or grows more, from any particular source is again a matter for data and analysis, and I don't argue it here. I can say what is relevant: The outcome changes from case to case but is more likely to favor letting other people keep their income to use as they see fit. This policy removes state interference and does not require the state to constantly think about which strategy might be better this year and which might be better next year. It does not require too much sophistication and fussing. In this case, simpler really is much better.

We can see that "there is no free lunch" (everything must be paid for, to give person A a break means to tax person B more) in the case of needy school children but we refuse to see it in the case of rich people and their incomes.

Rich people, business people, and politicians like to say they live according to the free market, the free market is a great institution, and we should interfere with it as little as possible. They usually invoke the slogans when they argue against an intrusion to help poor people or nature. If we intrude into the free market, we should do it as neutrally as possible. Everybody, in all classes, should face about the same distortion that comes from intruding into the free market. Taxes are an intrusion into the free market, one that we absolutely must make. If we must make it, then to preserve the free market as much as possible, we should intrude as evenly as possible. When we give tax breaks to the rich, we intrude into the intrusion so as to make the intrusion even less even and even more a distortion of the free market.

Tax breaks for the rich are an intrusion into the free market that distorts the free market as much as any program for the poor or for nature. To support the free market but also support tax breaks for the rich is hypocrisy. If you want to live by the free market, then you must really live by the free market, and you must be consistent. No tax breaks for the rich is consistent with free market ideology. Anything else is hypocrisy. You cannot have your cake and eat it too.

The sales tax is immoral because it cuts into the income of poor people enough to hurt them. Because of it, they can buy less food, clothes, heat, and school supplies. Even if poor people did have enough to pay the sales tax and still buy necessities, there is something intrinsically immoral about a tax that eats up 10% of the income of poor people but 1% of the income of rich people (I explain the figures in other essays). Tax breaks for the rich are the same. It is immoral to tax rich people more than poor people unless the resulting benefit to the nation, and so indirect the resulting benefit to poor people, is huge and crystal clear. Tax breaks for the rich is not like forcing everyone to get vaccinated for small pox or measles. Tax breaks for rich people is a shot in the dark at best. There is no justification for it that can override the bad smell and bad taste.

We have a plan that is good enough and distorts the free market economy least, described above and in other essays. We should just stick to what is simple and works.

Why, then, do various people continue to support tax breaks for rich people?

The question is especially acute because only a handful of economists, politicians, and rich people really believe the economic theory that is used to justify tax breaks for rich people.

The most obvious reason for rich people to support the policy is that it gives them more money. This is not as big a criticism as it sounds. Nearly all of us like more, and we like the programs and policies that give us more. Middle class people gain from programs to pay for tuition, benefit a lot from police and fire services, and benefit from parks and recreation. Poor people support politicians who push welfare and medical insurance. You get what your socio-economic class can get from the state. Once you start getting it, you don't want to stop. This is natural. It is wrong, but it is natural.

Rich people support tax breaks because they fear the opposite. They fear not just that people will make them pay their "fair share" but will "soak" or "gouge" them. They fear that, once taxes on rich people's incomes have begun, there will be no limit. This fear is somewhat justified. It has happened in the past, even in America. Believe it or not, rich people seek security just as much as everybody else, and a raid on their incomes is not just a raid on their incomes but is an attack on their security for themselves and their families. Rather than risk this, rich people feel it is better to support a policy that keeps the wolves at bay and keeps their incomes secure. The proper antidote to this natural fear of rich people is not to harangue rich people but to decide on a sound equitable tax policy and make sure that we don't deviate from that.

Politicians support tax breaks for the rich because rich people contribute to their elections.

More importantly, politicians support this policy because rich people can contribute to the election of their rivals. Once the idea of "less taxes for the rich" is in place, any politician who does not support the policy, and instead supports equitable taxes, will face another politician who does support "less taxes for the rich" and who is well-funded and well-backed. Guess who wins? In the end, all we have are the politicians who support "less taxes for the rich". Before you get too huffy, the same thing happens with a host of issues such as abortion and welfare.

Oddly enough, middle class and upper middle class people often support this policy too. It is hard to get a straight clear answer out of them as to why they support this policy, so I only report here the best that I could get. (1) They fear that, if the poor are able to tax the rich a lot, then they are next. To forestall an attack on their incomes, they use the rich as a bulwark. (2) Many dream about being rich someday, or being rich for their children. When they are rich, the want to keep what they have earned, and they want to give it to their children. By supporting the policy now, upper middle class people defend what they hope to have in the future.

Capital Gains.

Suppose you own 100 shares of "Gizmo Deluxe" stock at $100 apiece. At the end of next year, the stock has gone up to $200 apiece but you do not sell the stock. Is this gain income or not? Is this taxable or not? Should it be taxed? If this gain is taxed, will taxing badly affect investment? These questions are not easy, and people wage war in Congress over them.

Most of the income of rich people is in this form. If we tax it, then we would have to force stock owners to sell some of their stock to pay for the shares that they keep. Taxing it really does have a bad effect on investment. On the other hand, the owners still made a lot of money on the part they did keep, and it is likely they will want to keep investing because of what they did make. So taxing the increase in price of the stock, even if most of it is not sold, likely will not have too bad an effect on investment.

To the extent that I understand the tax laws, mostly we don't tax stock owners until they sell the stock. Then we tax them on the difference in price between what they paid and what they sold. We consider this gain to be income. Something along these lines seems reasonable. This is what I have in mind when I say we should tax rich people at about the same rate (or a little more) than other people.

The increase in the value of the stock is called a "capital gain". Whether it is taxed before selling or after selling, and how much in each case, are big questions that I can't go into much here.

Suppose the owner never sells the stock. In that case, the stock keeps going up in value about $100 per year; but that increase hardly seems like income to the stock owner because he-she never sells the stock and so he-she never really has cash in hand from the stock (or ATM card in hand) as does a working person from a paycheck (or direct deposit bank account). Not quite. The owner can use the stock as collateral for other business ventures, and so, in effect, the stock is wealth that increases as result of income whether it is ever "realized" (sold) or not. It is "paper" income that makes more "real" income. So maybe it should be taxed as income.

Rich people are quite clever at keeping their income in an un-realized form, and so hardly taxed at all, yet using their income to make more income. That is annoying to people who have to work for their daily bread and butter. But it might be that doing something about it would cause much more harm than good.

The question of capital gains is worsened by the role of inflation, but I only say that here to forestall the people who will say that I don't know about it.

In 2015, America taxed unrealized capital gain lightly (I forgot how much). (I don't own anything that does me much good from capital gain – if there is ever an inquiry by suspicious people who claim I am a hypocrite, I will reveal my meager finances). To tax unrealized capital gain lightly is a good idea. I don't know how much it should be taxed compared to realized income based on actual sales. That is another essay.

Now consider a rich person who owns a large tract of land. The land costs $25 million and the owner invests $25 million in building an apartment complex on the land. Total expenses are $50 million. The market value of the land and complex is $100 million, or $50 million over initial costs. The owner does not sell the apartment complex (not right away). The owner hires a management company and collects rent. After all expenses, the rent is $8 million per year, a return of about 16% on invested capital ($50 million) or about 8% on evaluated capital ($100 million). At these rates, if the owner did not have to pay taxes on the rent, the owner would get all his-her initial investment back after about 6 or 7 years. After that, the rent would be "pure profit" or "gravy". This scene is not far-fetched except that revenue from the rent likely is more. I ignore a lot of details.

Two other things go on at the same time. First, the complex goes up in market value every year up to about 25 years of age, after which it declines steadily. Second, although the complex rises in market value, the complex officially "depreciates" or loses value because it gets older. Things wear out and have to be replaced or cannot be replaced. Depreciation is mostly important for taxes until it begins to seriously affect market value after about 20 years. Officially the complex might have no value at all after 25 years although the land would still have value. I avoid these issues for this story, for the most part.

The revenue from rent is income and should be taxed as income. It should be taxed at a rate similar to the rate paid by poor people and middle class people. What actually happens is complicated and I don't know much of the story. Sometimes investors get an allowance on revenue until their initial investment is paid off ($50 million), after which they pay tax on revenue as profit. Even then, they do not often pay the same rate as poor people and middle class people. It might seem fair to allow an allowance until initial investment is paid off but I don't think so. It leads to abuses ("loopholes") that undermine the benefits of fairness.

The appreciation (increase) in value of the apartment complex (first from $50 million initial investment to $100 million initial value, and then something each year up to about 20 or 25 years) is not counted as simple revenue and is not taxed as income (profit). It is capital gains, or a similar category.

Owners-investors, management firms, accountants, and lawyers, are usually adept at labeling revenue from rent (and any source) as covered under recovering initial investment or as capital gains, even when it is not. They are good at legal "hiding". This is an example of the abuses that come of allowing owner-investors to pay lower rates of tax until the initial investment is paid off. This is not the only example of clever hiding. As a result, owner-investors pay even less a rate than the official rate, which is lower than the rate paid by poor people and middle class people. This is another reason to have a clear simple fair honest tax code.

Hopefully you can see why normal people get headaches about this matter and why investors and rich people keep armies of accountants and lawyers. There is no point to offer suggestions here because I can't go into the details and I don't know much anyway. Keep in mind that we (the state) have to make more money at catching people and making them pay their fair share than we spend catching them. The state has to make a profit in taxes. After a point, it becomes too expensive to fight rich people, their lawyers, their politicians, and adept hiding. After a point, the state makes more revenue by letting rich people have some loopholes. We try to minimize the damage.