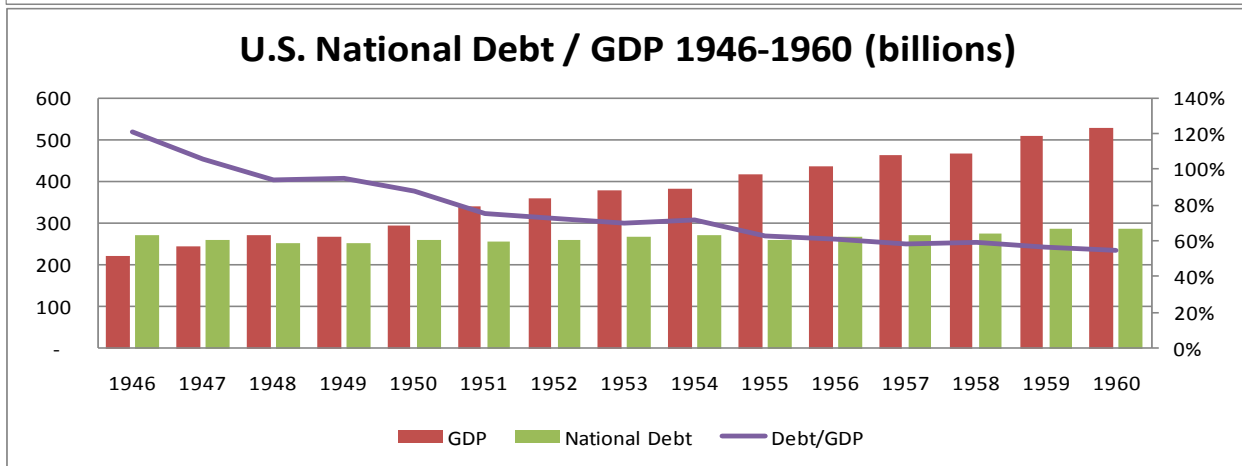
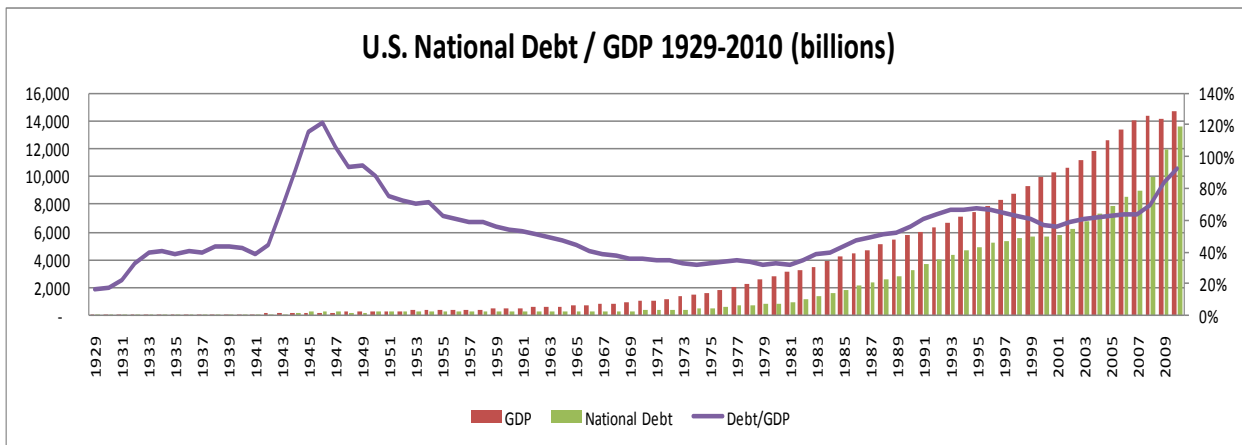


Taxing the Rich – A Brief Analysis

The U.S. Federal National Debt and the Debt/GDP Ratio:

At the end of the 2010 Federal Government fiscal year (Sept 30, 2010), the U.S. Treasury reported the national debt of \$13.6 trillion.¹ Dividing the figure by the Bureau of Economic Analysis' reported \$14.7 trillion in Gross Domestic Product (GDP), the National Debt/GDP ratio was 93%. The 2010 figure is the 6th highest in reported U.S. history². The 5 highest years, 1946-1950 were consecutive and marked a period of debt management following extreme, but temporary spending related to World War II. The all-time high National Debt/GDP ratio was set in 1946 when the National Debt reached 121% of GDP. However, it was generally understood that the debt would not continue to grow at a rapid pace after the war. In the 14 years following 1946, the Federal Government ran a fiscal deficit in 7 years and a fiscal surplus in 7 years. This necessary and laudable fiscal navigation held annual National Debt growth to 0.4% over the 14 year period, while annual reported GDP growth was 6.4%. In aggregate terms from 1946-1960, the National Debt increased by 6%, while reported GDP increased 137%. This sort of fiscal prudence (achieving a year of surplus for each year of deficits) is what the U.S. Federal Government will need to exhibit again if the National Debt/GDP ratio is to avoid its probable march beyond 100% and into unknown and inadvisably risky territories.

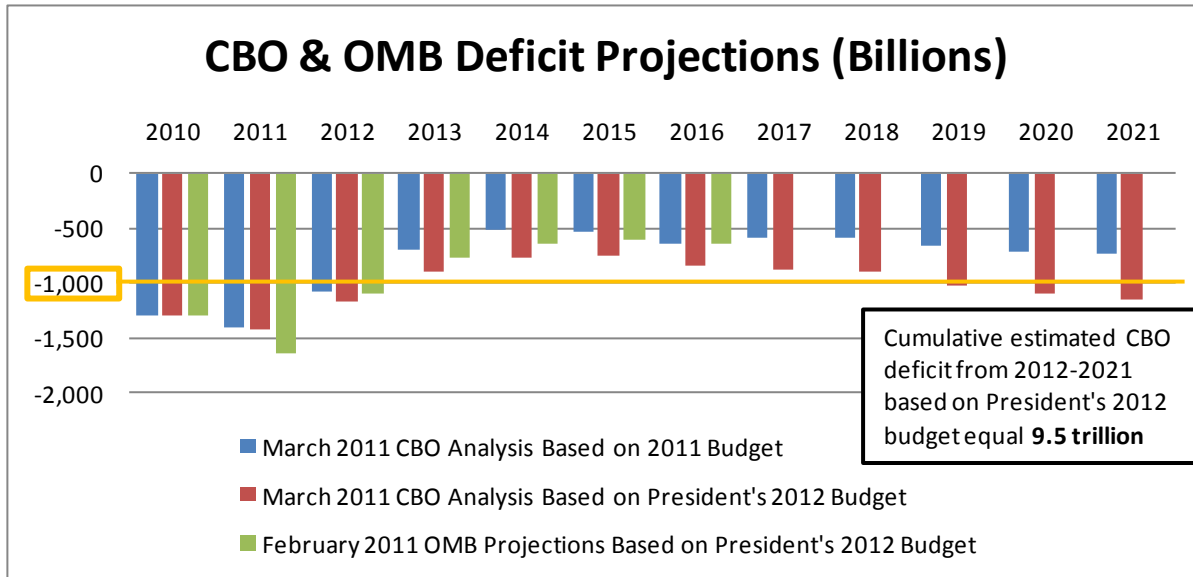


Source: BEA.gov and TreasuryDirect.gov

¹ In February 2011 (just 5 months later) the figure reached \$14.2 trillion.

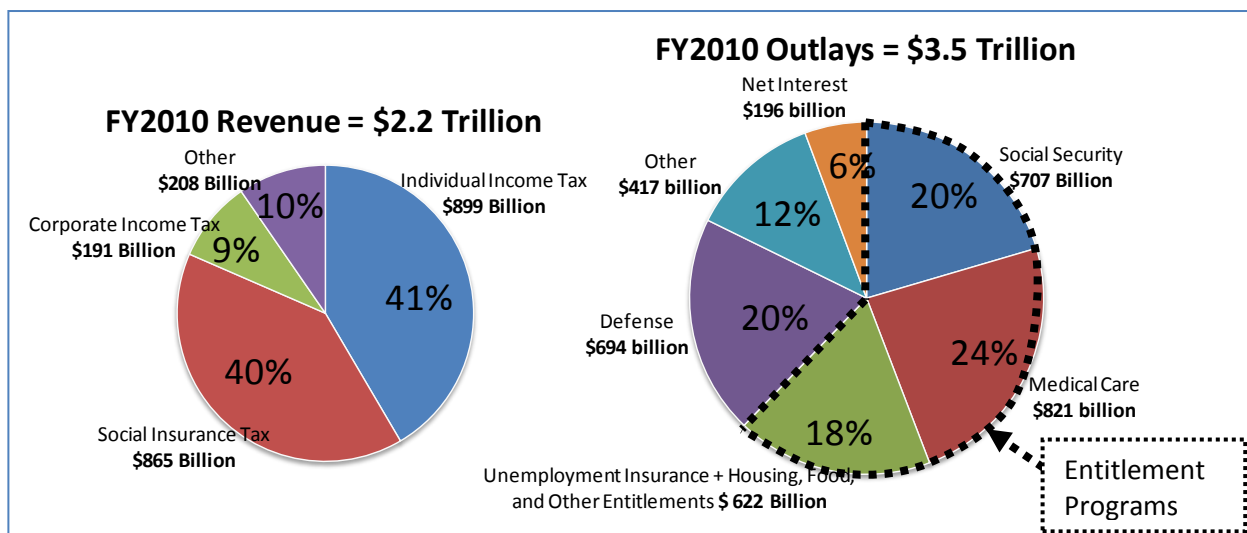
² While GDP figures have only been reported using a consistent framework since 1929, the national debt has been reported since January 1, 1791 when it stood at \$75.5 million.

However, neither the projections of the U.S. Office of Management and Budget (OMB) nor the projections from the Congressional Budget Office (CBO) leave much hope the United States will run anything besides large deficits through the end of their respective forecast periods.



Source: CBO.gov/budget & OMB Table 1.1

Critically, the driver of the deficits (the gap between government revenue and spending), is not temporary conflict-related spending this time around, but is instead structural: a consequence of generous social security, medical, and other entitlement spending, which carry no end-date and are designated as “mandatory” spending within the Federal budget.



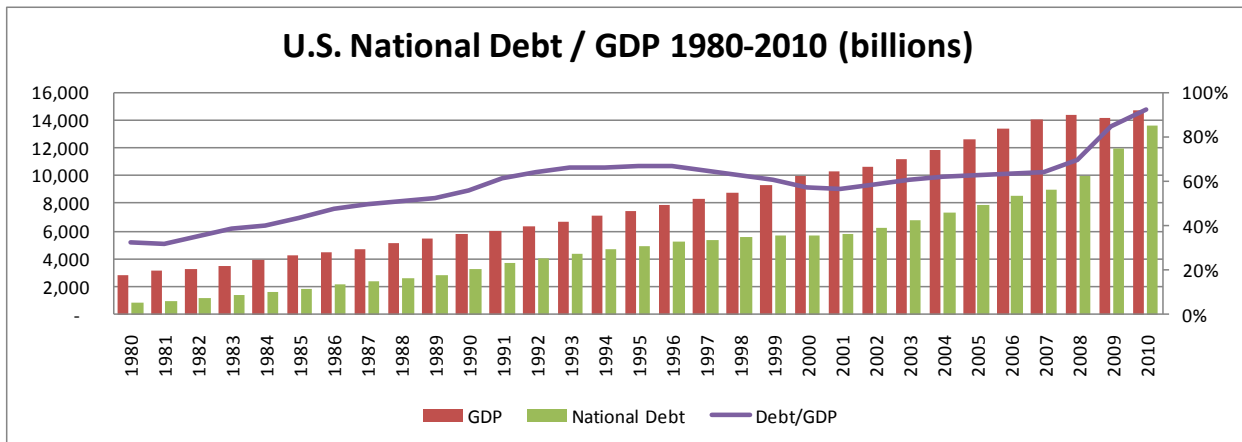
Source: OMB Table 2.1 and Table 3.1

The OMB and the CBO each provide graphical representations of Federal spending on their respective websites, which some readers may prefer to the pie-charts above.



Source: <http://www.whitehouse.gov/omb/budget> <http://cboblog.cbo.gov/?p=1933>

Every year that spending is greater than revenue, the Federal National Debt grows. The national debt has grown from \$0.9 trillion in 1980 to \$13.6 trillion in 2010, which represents a 9.5% compound annual growth. Since 1980, the national debt grew at a faster rate than reported GDP in 23 of 30 years driven by increases across the board.

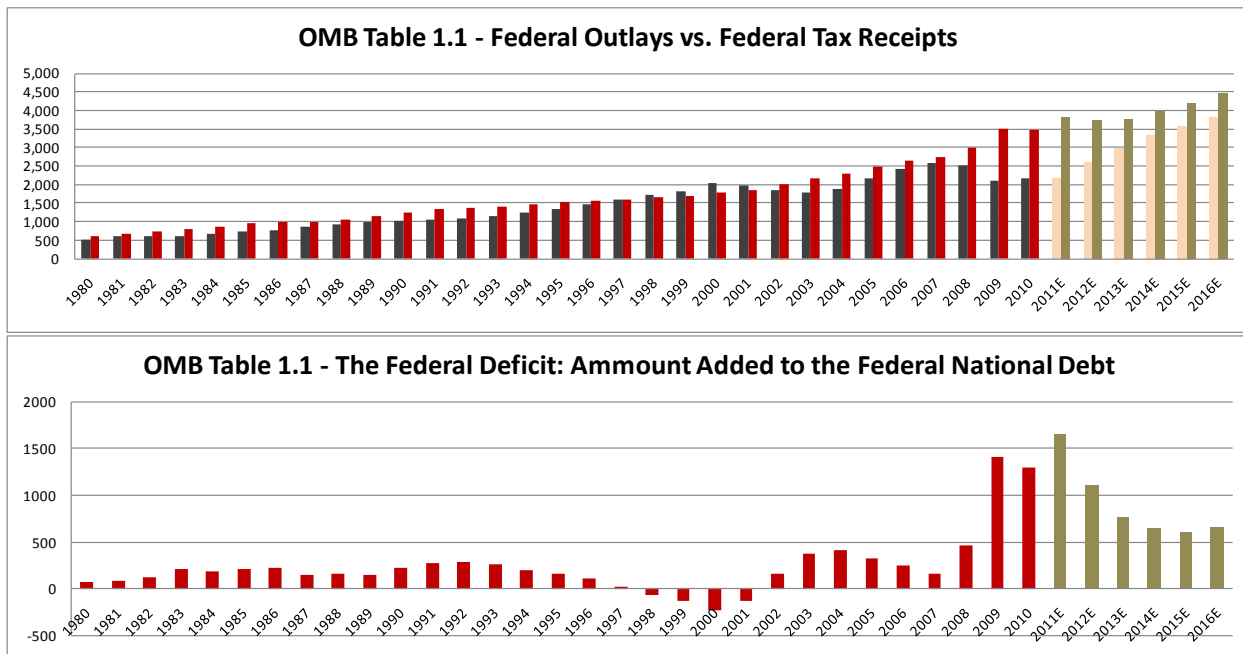


Source: BEA.gov and TreasuryDirect.gov

The Federal Deficit in Fiscal Year 2010:

In fiscal year 2010, the U.S. Federal Government generated \$2.2 trillion in revenue (tax receipts) and spent \$3.5 trillion (outlays). The resultant \$1.3 trillion deficit was added to the National Debt in 2010. The Office of Management and Budget (OMB) estimates the fiscal year 2011 deficit to be an even larger \$1.6 trillion. The deficits are projected to decline from that high level in FY2012; however, deficits are expected to remain at dangerously high levels for as far as the eye can see.

In order to bring down the National Debt/GDP ratio, it will be necessary to achieve historically small fiscal deficits or preferably fiscal surpluses. Given OMB projections, Federal deficits are projected to be greater than \$600 billion even in the terminal forecast year 2016. However, we would point out that the CBO projections are higher than the OMB projections in each forecast year, and they show the deficit growing significantly in the back half of the next decade.



Source: OMB Table 1.1

From 1901-2010, the U.S. government has generated a fiscal surplus (spent less than it generated in tax revenues) on 31 occasions. However, this has only occurred 4 times in the past 40 years. It is no coincidence that sequential expansions in large “mandatory” spending programs such as Social Security and Medicare have coincided with this reduced likelihood of running occasional fiscal surpluses.

Time Period	1901-2010	1950-2010	1970-2010	2011E-2016E
Years of surplus	31	9	4	0

Source: OMB Table 1.1

Over that same 40 year period, Federal spending on Medical Care has grown at 11.1% annually and spending for Social Security has grown at 8.2% annually, both outpacing population growth of 1.4% annually and reported GDP growth of 6.8% annually.

Growth in GDP and Government Spending	1970-2010	1980-2010	1990-2010	2000-2010
Years of compound growth	40	30	20	10
Inflation (CPI)	4.6%	3.3%	2.6%	2.4%
Population (non-institutional civilian)	1.4%	1.2%	1.2%	1.1%
GDP	6.8%	5.7%	4.7%	3.9%
Social Security	8.2%	6.1%	5.4%	5.6%
Medical Care	11.1%	9.4%	8.7%	8.8%
Unemployment, Housing, Food, Other Insurance	9.6%	6.8%	7.4%	9.4%
Defense	5.5%	5.6%	4.3%	8.9%
Net Interest Payments	6.8%	4.5%	0.3%	-1.3%
Other	5.9%	3.6%	3.3%	5.0%
Federal Government Outlays (spending)	7.4%	6.1%	5.2%	6.8%

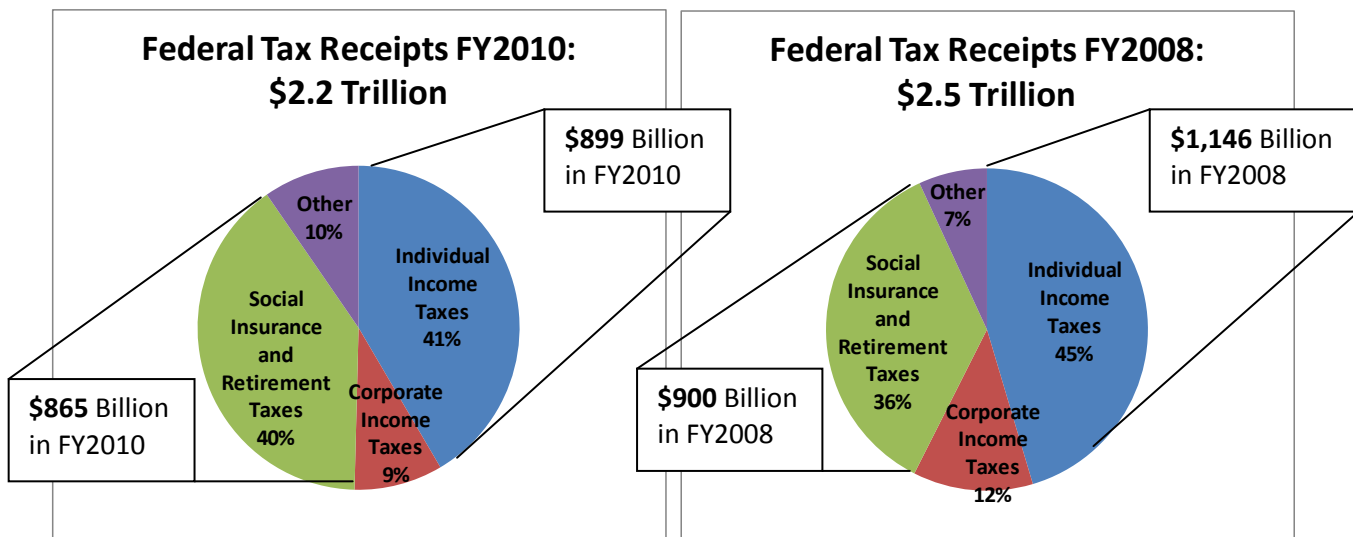
Source: OMB Table 3.1, BEA.gov (GDP), BLS.gov (CPI), and BLS.gov (population)

To close the \$1.6 trillion fiscal year 2011 budget deficit, could we just tax the rich?

On February 15, 2011, Clinton labor secretary Robert Reich reiterated his preference for moving the top marginal federal income tax bracket from 35% to 70%. He wrote, "It will soon become evident to most Americans that the only way to reduce the budget deficit, preserve programs deemed essential by the middle class, and not raise taxes on the middle, is to tax the top (our emphasis)." (Feb 15, 2011 [Robert Reich](#))

A number of pundits and interest groups have suggested that increasing taxes on wealthy Americans would close the deficit and solve the problem. We believe that the tax system is poorly designed and rife with loop-holes and we support the notion that the wealthy should pay a healthy share of the tax burden. However, in order to reach beyond the realm of "popular assertion" and into the realm of "viable solution," the basic arithmetic must hold. In this case, it does not.

In fiscal year 2010, the U.S. Federal Government generated \$2.2 trillion in tax revenue. 40% of this government revenue (\$865 billion) came in the form of various payroll taxes (social security, etc.) generally totaling 15.3% of wages.³ The next 41% of tax revenue (\$899 billion) comes from the Individual Income Tax, which is Congress' main tool for adjusting taxes up or down.



Source: OMB Chart 2.1: Tax Receipts by Source

One particularly common popular proposal involves taxing those who earn more than \$1 million per year at a much higher tax rate. According to IRS data from fiscal year 2008 (the most recent available), 321,294 U.S. tax returns reported an adjusted gross income (AGI) of over \$1 million.

³ <http://www.taxfoundation.org/publications/show/25415.html>

FY2008 Size of Adjusted Gross Income		IRS SOI Table 1.4 - Numbers in billions unless otherwise noted				
Tax Filings Sorted by Adjusted Gross Income Level	Returns Filed (thousands)	Salaries and Wages	Adj. Gross Income	Deductions & Exemptions	Taxable Income	Income Tax
\$1 and up	139,961	5,927	8,427	2,290	5,653	1,107
\$200k and up	4,376	1,206	2,462	411	2,061	554
\$500k and up	899	540	1,469	207	1,271	357
\$1 million and up	321	330	1,076	145	938	260
\$10 million and up	13	75	400	53	348	88

Source: IRS Statistics of Income Division (SOI) Table 1.4

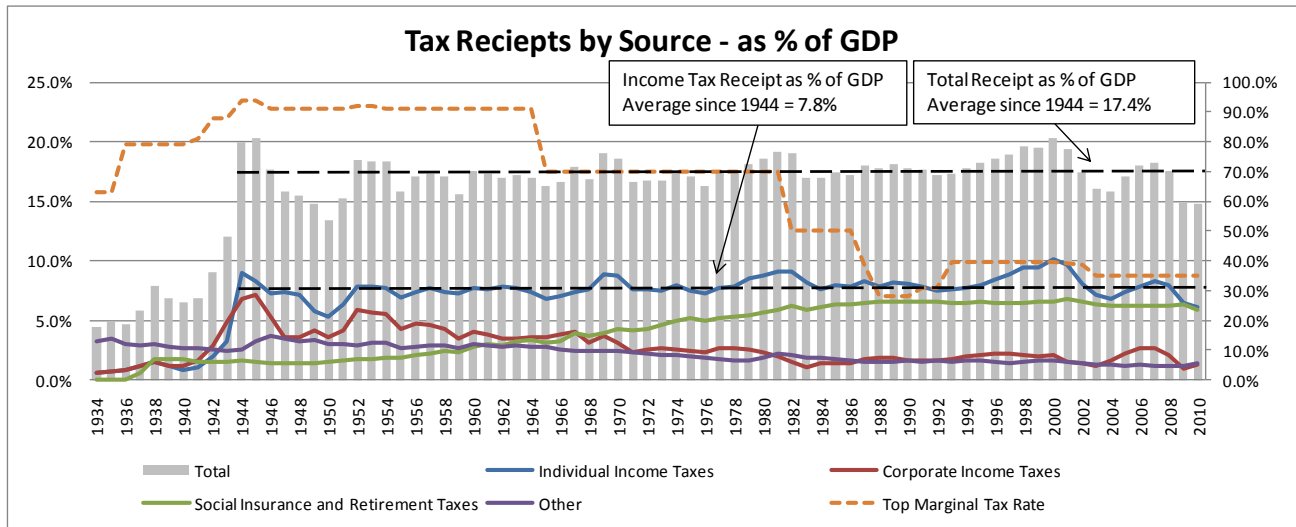
The group that reported \$1 million or more in AGI in 2008 reported an aggregate AGI of \$1.08 trillion in fiscal year 2008. After deductions and exemptions as well as other adjusting factors, this group reported taxable income of \$0.94 trillion. Those reporting an AGI of over \$1 million contributed \$0.26 trillion in individual income taxes, or 23% of the total contribution. If their tax contribution were somehow doubled to \$0.52 trillion, it would represent an additional \$0.26 trillion in Federal tax revenue, or just a paltry 15.8% of the OMB projected 2011 Federal Deficit.

Tax increase: filers reporting an AGI of \$1 million or more	Income Tax Revenue (Billions)	New Tax Revenue	Percent of FY2011 Budget Deficit	OMB Projected 2011 Federal Deficit
Income Tax Revenue in FY2008	\$260	\$0		
25% Increase	\$325	\$65	4.0%	\$1,645
50% Increase	\$390	\$130	7.9%	\$1,645
100% Increase	\$520	\$260	15.8%	\$1,645
Let's just take every taxable dollar earned	\$938	\$678	41.2%	\$1,645

Source: IRS Statistics of Income Division (SOI) Table 1.4 and OMB Table 1.1

Is it possible to raise taxes on the rich and generate a bit more revenue for the Federal government? Yes, of course. Could a strategy focused on raising the top marginal tax rates close the budget deficit? No, the math does not come close to supporting this. The numbers are sobering, and they illustrate that while taxing the rich is a popular idea, a strategy for closing the Federal deficit based solely on taxing the rich is not a serious solution.

It gets worse. History has proven that raising the top marginal tax rates generates a great deal less government revenue than legislators hope. This is because those affected by higher marginal rates make a concerted effort to receive or realize their wealth in various ways that do not expose them to high marginal rates. As just one of many potential examples, when confronted with high marginal tax rates, a business owner may choose to retain earnings in his business, receive more of his compensation in perquisites (e.g. company car), or pay earnings out as dividends as an alternative to paying himself a high salary taxed at high rates.



Source: OMB Table 2.1, BEA.gov, and TaxFoundation.org

History has demonstrated that aggregate tax revenue is effected surprisingly little by changes in marginal tax rates. Since 1944, aggregate individual income tax receipts have remained within a tight band near 7.8% of GDP, despite the fact that top marginal tax rates have ranged from 91% to 28% over the same period.

Conclusion:

The U.S. Federal Government has accumulated deficits by spending at a rate that has outstripped both growth in tax receipts and even reported GDP growth for decades on end. The OMB projected Federal budget deficit is expected to be an astonishing \$1.6 trillion in 2011, adding to the \$13.6 trillion Federal National Debt. The reduction in the National Debt/GDP ratio in the wake of World War II provides an excellent example of fiscal prudence; however, the challenges today are different as spending decreases will need to be deliberate and they will likely prove to be difficult political decisions. Many have suggested reducing the deficit by raising taxes on the very wealthy. Though this idea is popular, doubling the taxes paid by those that earn \$1 million or more annually would address less than 16% of the 2011 deficit. Further, adjusting the highest marginal income tax bracket is likely to raise less revenue than legislators project as taxpayers recognize earnings and gains in ways that minimize the tax burden.