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THE CHALLENGES OF TAXING THE BIG

LOS DESAFÍOS DEL GRAVAMEN DE LAS RENTAS ALTAS

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ABSTRACT

Over the past three decades the income distribution of various advanced countries and especially of Anglo-Saxon countries has become much more uneven than in earlier decades. Several theories have been advanced to explain this change. This paper focuses on the role played by changes that took place in the “architecture” of the income taxes. The changes were promoted by theoretical arguments and empirical studies, presented by some leading economists, that argued that lower income taxes, especially on individuals at the top of the income distribution, would generate significant beneficial results. The paper challenges some of these arguments and concludes that the lowering of tax rates on high incomes was a major reason for increasing income inequality.

Keywords: Taxes; Income Taxes; Inequality; Globalization; Incentives; Market Economy.
Desde hace tres décadas, ha aumentado la desigualdad en la distribución de ingresos de varios países desarrollados, y en especial, los países anglosajones, en comparación con décadas anteriores. Se han aportado varias teorías que explican estos cambios. Este artículo se centra en la influencia que han tenido los cambios en la “arquitectura” de los impuestos a los ingresos. Estos cambios fueron promovidos mediante argumentos teóricos y estudios empíricos, presentados por economistas de alto nivel, que argumentaban que bajar impuestos, especialmente a aquellos que se encontraban en el nivel superior de ingresos, generaría efectos beneficiosos. Este artículo pone en cuestión algunos de estos argumentos y concluye que la bajada de impuestos a las rentas más altas ha sido determinante para el incremento de la desigualdad.

**Palabras clave:** Ingresos tributarios; Desigualdad; Globalización; Incentivos; Economía de mercado.

**JEL Codes:** B20, E62, H20, H31, J20, P10.
1. INTRODUCTION

The challenges of taxing individuals at the top of the income scale (“the big”) exist in all countries with a market economy. The challenges can be: political, because “the big” normally have a lot of political power; administrative, because the rich can often hide or spread their income easily in activities that are not easy to control, including in foreign tax havens; and, legal, because they can hire the best accountants, lawyers and tax experts that can help them exploit the complexities of the tax systems and, through lobbying, can promote legal or administrative changes favorable to them. They can also occasionally bribe the tax administrators or politicians, to get favorable treatment.

This paper will focus on the role that economic theories played in recent decades in reducing the taxes that the big pay. The theories often originate in the developed world, and especially in the United States. However, they end up having influences in other countries, including developing countries. The paper will have a US bias, but in a concluding section it will address directly but briefly the developing countries.

2. SOME HISTORICAL BACKGROUND

Two thousands years ago, the great, Greek, historian Plutarch (45-120 AD) wrote that: “An imbalance between rich and poor is the oldest and most fatal ailment of all republics”. His view was echoed by others over the centuries, and, in spite of some dissenting voices, would be endorsed today by many. Closer to our time, a Swedish dramatist, August Strindberg (1849-1912 AD) wrote that: “Economics is the science by which the economic elite remains the economic elite”.

The Strindberg view was recently endorsed and backed by a prize-winning documentary, called The Inside Job, on the causes that led to the financial crisis and to the “Great Recession”. The documentary attempted to show the role that several highly influential economists had played, before the crisis, in insuring that “the economic elite remains the economic elite”. The accusation by the documentary was that these economists had adjusted their writing, at times in

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exchange for financial compensation, to support the positions of the elite, and to promote the interests of those who could be called “the big”. Putting it in a more direct and less elegant way, the documentary implied that “they had sold themselves and their intellectual integrity”!

The American Economic Association has taken the accusation seriously enough to introduce a policy that requires that people who submit papers for publication in its journals must, from now on, disclose if they have received financial support for the work submitted.

Perhaps, the major issue was not one of selling one’s integrity, even though several of the economists interviewed had received significant amounts of money for writing and publishing papers that clearly supported the interests of some elite, but simply of endorsing a view that Ron Suskind, Pulitzer Prize winner and author of a highly informative book on the first two years of the Obama Administration, attributed to Larry Summers. See Confidence Men, 2011, p. 231. The Summers’ reported position was that, in a market economy, as is that of the United States, individuals always “get what they deserve”, regardless of the size of the incomes that they receive from their economic activities. Therefore, “the big”, those who get incomes in the millions, or even in the billions, of dollars, including, for some of them, huge bonuses, even when their banks or enterprises lose money, deserve their high compensations because of their greater ability, education, hard work and effort, compared with other individuals. These incomes are, presumably, a reflection of the “value” that these individuals contribute to the economy, with their activities.

The conclusion by Larry Summers would apply to those who are at the top of the income distribution as well as to those who are at the bottom. A possible exception to the above rule might be provided by those who receive minimum wages, or government subsidies. These individuals, by definition, must have contributed less “value” to the economy than the wages that they receive. There are, of course, many economists and politicians, especially in the United States, that would share this conclusion. Presumably the payments received by the economists for the papers mentioned in The Inside Job must also have reflected the real “economic value” provided by those papers.

If individuals always get the incomes that they deserve, and if, by doing so, they generate an income distribution that is highly uneven, it would seem unfair and some or many economists would add, inefficient, for governments to interfere with the results of the market. One cannot argue that individuals always get what they deserve while, at the same time, complain about the market results in terms of income distributions.

A complication is that societies need governments, and governments need revenue, to cover their spending. Thus, there is the necessity to raise taxes, and the problem of deciding what taxes to use and who should pay them. The Italian Scienza delle Finanze, an important “school” that flourished in Italy, from about the time of the Italian Unification, in 1861, until the advent of fascism, in the 1920s, had a simple answer. Some of its major exponents maintained that the government’s provision of public goods benefited the citizens in a relation
broadly proportional to their incomes. Thus, on a “benefit received principle”, this would justify proportional taxation. See Tanzi, 2011.

The above answer, in turn, created some controversy on whether the proportional taxation should be based on income or on consumption. The latter would exempt from taxation the part of income that is saved by taxpayers. Several major economists, including John Stewart Mill, Luigi Einaudi, Nicholas Kaldor and some others, over the years, argued that saving should not be taxed. Thus, in a way, they created a first bias in favor of richer people, who presumably save a larger share of their incomes, a conclusion that was later challenged by Milton Friedman and some other economists, who believed that, over the long run, the saving behavior of rich and poor people is statistically not distinguishable.

For much of the 19th century proportional taxation remained the accepted norm, so that the economic positions of higher income individuals, including “the big”, were not endangered by taxation. Also, the tax levels, as shares of GDP, remained low, generally below 15 percent, and progressive taxes remained unpopular. The 19th century economist John McCulloch best captured the prevailing view at that time. He was a firm opponent of progressive taxation, on the ground that, once proportional taxation is abandoned, “you are at sea without rudder or compass, and there is no amount of injustice or folly [that] you may not commit”. He was right, that proportional taxation provides a clearer compass for governments than progressive taxation, which comes in various shapes and forms. However, even for proportional taxation there is the question of determining the level of the tax rate and the use of the taxes collected.

The complications and the difficulties started when the right to vote was extended from a very small and rich proportion of the population to much of the population, who wanted more public spending, that would be beneficial to it, and more taxes imposed on the rich. Showing the impact that political winds have on the thinking and on the findings of economists, at about the same time, the then very popular German economists, Adolph Wagner, started arguing that governments do not have just the responsibilities of providing public goods (and, perhaps, of assisting the very poor) but also that of engaging in some redistribution of income across classes. This was a view found already in Aristotle—Politica, book V, Chapter 1— and in Montesquieu—Esprit des Lois, book V, Chapter VI and VII. However only in Wagner’s time this idea found a fertile ground. The socialists, including Karl Marx, were not in favor of redistribution of income, in the context of a market economy with private property; they, rather, favored abolishing private property and private markets.

In Wagner’s time the income distribution became an important issue and its measurement an important statistics. The “Gini coefficient” was proposed by the Italian statistician Corrado Gini, in 1912, as a way to measure the income distribution. It soon became a popular measure of it. If a more even income distribution was a desirable objective for many governments, the inevitable question arose as to how to promote it. Progressive income taxes entered the stage at this time. In the United States the income tax was introduced in 1913 the year after the Gini’s introduction.
Slowly the view acquired currency (a) that governments should have access to higher resources than in the past; (b) that income taxes could play a significant and growing role in providing the needed resources to governments; and (c) that income taxes could and should be progressive. By the middle of the 20th century this view had become prevalent and widely popular. See Tanzi, 2011. At the time when the author of this paper was a graduate student at Harvard, a half century ago, the above view was hardly ever challenged. At that time influential economists, such as Richard Musgrave, Richard Goode, Joseph Pechman and others strongly advocated the use of personal income taxes, applied with highly progressive rates, and based on a comprehensive definition of income that, in principle, should include unrealized capital gains.

There was almost no attention paid at that time, to the possibility that there could be significant disincentive effects that accompanied high marginal tax rates. Paul Samuelson, in his Foundation of Economic Analysis, published in 1948, had dismissed this as a serious possibility. At that time, surveys of American taxpayers published by the American Enterprise Institute indicated that they considered the highly progressive personal income tax as the "fair-est" of all taxes.

There was also almost no concern with the view, now frequently heard, that the rich are the ones that create employment and generate growth, so that, as some now argue, it would be a good policy to protect their incomes against high tax rates. There was also no concern about powerful disincentive effects that could reduce the "economic value" that "the big" might contribute to the economy. Most economists held these views until the decade of the 1970s.

In the period up to the 1970s, tax rates went sharply up, and the Gini coefficients remained generally low. See Alvaredo et al, 2013. The Gini had declined sharply from the peak reached in 1929. The lowest level for the Gini coefficient in the United States (and in other advanced countries) was reported around the years 1960s and 1970s, when marginal tax rates were very high. It would remain broadly unchanged until it started to increase, first slowly and then at an accelerating pace, in the 1980s and in later years.

The (US) Tax Foundation has published data that indicate that the effective, average income tax rates on US millionaires rose from 1.6 percent in 1913, the year when the income tax was introduced in the USA, to reach 66.4 percent in 1945, during the war. It was still 55.3 percent in 1965 and 47.7 percent in 1982. It fell rapidly afterwards, to reach the current low levels in which Governor Romney could report, for recent years, a rate of around 13 percent on his multi million dollars income.

The economists’ challenges against high tax rates started in the 1970s and became more organized and more forceful in later years. The challenges were based on both theoretical arguments and on some empirical results. Soon the landscape for income taxation would change in fundamental ways. See Tanzi, 1988.
3. “The Big” Strike Back

A first theoretical attack against high marginal income tax rates came from some economists who recognized that, while the money earned from work and from additional effort was taxed, and often at very high tax rates, the psychic income that came from not working, that is from leisure activities, was not taxed. This implied that leisure was both a desired and often a subsidized activity, and that when the government subsidizes something, especially a desired commodity or activity, it ends up getting more of it. This argument acquired currency especially in an environment in which the welfare states, that had come into existence at that time and that was growing rapidly, presumably gave, some or many, individuals the option of not working, by living on public subsidies. Faced with having to pay high marginal tax rates, when they worked, some individuals would choose not to work and enjoy leisure, claiming public assistance; or they would choose to work less; or they would opt for lesser paid, but less demanding, occupations. Some economists began to fear, that these decisions would reduce incentives to work and, consequently, economic growth.

A second theoretical challenge had to do with the consumption function; or better with the response of personal saving to the taxation of interest income. Keynes had dismissed the possibility that the net-of-tax rate of interest could affect the decision to save or consume. For him consumption depended on income and on little else. However, in the 1970s some economists started challenging the Keynesian conclusion. The argument was that the supply of saving is elastic with respect to the net return that individuals get when they save. The choice between present and future consumption was assumed to depend on the net-of-tax real interest rate. High marginal income tax rates on interest income reduced the net of tax rate of return to saving; thus, they were assumed to reduce the rate of saving, affecting, as a consequence, investment and the growth rate. At that time, in the full swing of the “supply side revolution”, a paper by Michael Boskin, a professor at Stanford University, was particularly influential. Using new data, and new econometric techniques, Boskin claimed to have identified a high response of saving to the real rate of interest.

The third challenge against high marginal tax rates came from an unusual source, a curve drawn on a napkin, in 1974 in a Washington restaurant, by an economist called Arthur Laffer. This came to be called the “Laffer curve”, an economic concept that, in spite of its questionable analytics and unusual place of birth, became one of the best-known concepts in economies. See Tanzi (2014). The Laffer curve became a powerful “propaganda devise” against the use of high marginal tax rates and was used extensively, by conservative economists and by politicians, to push for lower tax levels and tax rates. See Malabre (1994).

Up to the 1970 there had been little empirical work on the relationship between high marginal tax rates and the supply response by labor and saving to high tax rates, and, indirectly, on the relationship between high tax rates and economic growth. In the earlier years, until that time, various governments, in-
cluding those of the USA and the UK, had not refrained from taxing income at rates that at times reached or even exceeded 90 percent. These high rates reflected the governments’ need for higher revenue and their objective of improving the after-tax income distribution. They had also the aim of making high-income individuals, “the big”, contribute more to the financing of public spending.

In the 1970s and early 1980s there began to appear what at that time were called “second-generation econometric studies” that, using new econometric techniques and new data, attempted to measure the impact of high taxes on various economic variables, such as work participation, saving rates, participation of women and second workers in the labor force, hours of work, and so on. This was happening at the same time when the political and intellectual climate with respect to high taxes and tax rates was changing in part because of the influence of the ‘supply side revolution’. This coincidence implies, or warns, that economic findings are often not random results, from objective and unbiased research activities, but often responses to political signals and political incentives. We economists look where the political signals indicate that we should look and often make an extra effort to get the results that are more in line with the climate. Often this happens subconsciously. However, it may also happen as the result of financial incentives, as The Inside Job claimed.

At that time conservative economists, especially from the “Chicago School”, such as Milton Friedman, had become influential and very conservative political leaders had come into powers, in countries such as the USA, the UK, New Zealand and some others. This political environment gave traction to some of the new economic findings. For example, the Laffer curve became a major propaganda tool for the Wall Street Journal’s editorial page. In the space of six years, the marginal tax rate for the US Federal income tax was reduced from 70 percent to 28 percent, with the legislation of Ronald Reagan’s “fundamental tax reform” in 1986. The same happened in some other countries. See Tanzi, 1987.

Until 1986 it was the marginal tax rates and the progressivity of the tax system that had been under attack by conservative economists, not what could be called the architecture of personal income taxation. The 1986 Reagan fundamental tax reform, while sharply reducing the tax rates, still accepted the Haig-Simons, or the Hicks, view that income is income, regardless of its source, and that it should be taxed in its entirety without discriminating among different sources.

However, soon the architecture of the income tax system came under attack, facilitated by another ongoing development: the growing globalization of economic activities and the beginning of the globalization of the financial market. Globalization made financial capital, in particular, and capital, in general, more mobile than labor. It made, thus, its supply potentially more elastic, with respect to the tax rates that a country imposed. Capital could fly to areas where it was more lightly taxed. As a consequence, the taxation of capital in its various forms (capital gains, dividends, corporate income taxes, taxation of interest income) started being attacked. See also Keen and Konrad, 2012, for some technical details.
The initial attacks came from economists such as Robert Lucas, Larry Summers and some others. By 1990 Lucas had concluded that “neither capital gains nor any of the income from capital should be taxed at all”, a position that was soon endorsed by other conservative economists. Lucas believed that the elimination of capital income taxation would lead to an increase by about 35 percent in the US capital stock, that would stimulate growth, and that this elimination would be “the largest genuinely true free lunch…” How, in the meantime, the government spending commitments would be financed was not discussed by Lucas. Summers also theorized about the existence of large income gains for the United States that could come from the elimination of taxes on capital, because capital not taxed would not have an incentive to emigrate. The higher capital-labor ratio that would result would in turn raise the workers’ productivity and their wages, making everyone, including the workers, better off. This was a classic “win -win” situation.

These and related attacks, including papers by other economists that believed that taxes on capital income should be reduced, possibly to zero, started the strong attack on the architecture of the personal tax system. In these new rounds of attacks, it was not just the marginal tax rates and the progressivity of the whole tax system that were under attack, but their architecture. The principle of equal treatment of income, regardless of the source, went out of the window and the need for, or the benefit of, discrimination in favor of capital incomes (capital gains, dividends, corporate income taxed, and, progressively, other kinds of capital incomes) came to be accepted. Of course, large capital incomes often go to “the big”, so that they are often the, direct and immediate, beneficiary from the changes. The workers might, in theory, and indirectly, benefit from the changes, but with potentially long lags if ever, and with far more uncertainty.

4. Tax rate reductions and income distribution

There is no controversy about the fact that the income distribution has become much less even in the Untied States and in several other, and especially Anglo Saxon, countries in the past three decades. The worsening of the income distribution has accompanied closely the tax changes described earlier. See, Alvaredo et al. (2013), especially Fig.3 on p. 7. Although, the income distribution of a country can change for several reasons, and various theories have been advanced by economists to explain the changes, it would be indeed strange if the changes in the tax systems described above did not play a significant role. In this section we describe some of the changes in the income distribution in the USA

The lowering of tax rates on high incomes and especially the separate and much lower rates applied to dividends, capital gains, “carried trade”, and some other forms of income, received by high income individuals, led: (a) to immediate net-of-tax income gains to those with high incomes, and especially to “the
big”; (b) to increasing attempts on the part of the latter (CEOs of corporations, heads of hedge funds, and of private-equity firms) to reclassify the income that they received as long term capital gains, in the USA taxed at only 15 percent; and (c) led to a dramatic increase in the share of total net-of-tax income received by the top income players, and especially by those in the top 0.1 percent (one per thousand) of the income distribution. “Carried trade,” a term that did not exist in the past, became a popular, and an increasingly contentious, income. Some individuals, who earned millions, or even billions, of dollars, paid only 15 percent on that income and ended up paying lower tax rates than their drivers or secretaries, as Warren Buffet has often stated. Furthermore, unrealized capital gains continued not to be taxed.

Apart from the problems related to the attempts to reclassify incomes, in order for “the big” to benefit from the lower tax treatments of capital incomes, there was the problem that, while the benefits of these tax changes to the super rich were certain and immediate, the expected or predicted advantages to the working class, as theorized by Lucas, Summers, Boskin, and others, were highly uncertain. If they do occur, for sure they must be much delayed. So far, there has been no evidence of those beneficial effects on workers. In the Untied States, especially the predicted benefits for workers seem to have remained mostly in the theoretical papers of those who had predicted them.

The share of total taxable income that the top 0.1 percent of taxpayers in the US received in 2005, before the Great Recession, reached almost 8 percent, and that received by the top one percent reached 17.42 percent. See Atkinson et al, 2011. It should be recalled that unrealized capital gains are not included in these statistics so that the share of the top income earners were probably even higher. According to data issued by the Congressional Budget Office, 2011, the top one percent of the taxpayers, that in the 1960, and 1970s had received about 10 percent of total income, by 2007 was receiving close to 25 percent of total income. See also Alvaredo et al. (2013).

These were extraordinary increases and percentages. They were much higher than in any other industrial country, for which data are available. Ibid. The behavior, but not the size, of the income going to the top one percent in the USA was duplicated to a lesser extent by that of other Anglo-Saxon countries, (Canada, Ireland, United Kingdom, Australia and New Zealand), which had followed tax policies that were broadly similar to those followed by the United States, but much less by most non Anglo-Saxon European countries and Japan. As Alvaredo et al. (2013, p. 8) have recently put it, “... countries such as Germany, Spain or Switzerland, which did not experience any significant top rate tax cut, did not show increases in top 1 percent income shares”.

In the United States, an unusual situation has developed, whereby about half of the population (mostly the lower income individuals), does not pay any income taxes, because of claims to high deductions and to high personal exemptions, or because of low incomes. According to the IRS, in 2009, this non paying group also included anywhere between 10,080 and 35,061 households, that reported adjusted gross incomes that were at least $200,000 but
that, because of high deductions, paid no Federal income taxes. They also did not pay value added taxes, because the USA is the only OECD country without some version of such a tax. Thus, the bottom half of the population pays little taxes while “the big” pay much lower taxes than in the past on their larger incomes. Inevitably, the tax burden on the working middle class, that has seen real wages stagnate for decades, has increased.

In 2010, mainly rich, US taxpayers reported $310 billion in (realized) capital gains, mostly taxed at 15 percent. The Congressional Joint Committee on Taxation has estimated that the preferential taxation of (realized) capital gains and of dividends in 2010 cost the US Treasury $93.1 billion.

As mentioned, the reduction in tax rates at the top and, in part, at the bottom has led to a larger contribution to taxation by the middle class and, more importantly, from a macro economic point of view, also to a reduction in total tax revenue. The United States is the only OECD country in which the total tax level, as a share of GDP, is now the same as it was 50 years ago, surely a remarkable result. In all other OECD countries the total tax level increased significantly over that period.

Unfortunately, for good or bad reasons, public spending is not what it was 50 years ago. This disparity between spending and tax revenue has created enormous fiscal deficits and a fast growing public debt that has now reached dangerous levels. There are also enormous future government liabilities that, somehow, must be dealt with. Without some major policy changes in the near future, the US may be moving toward a fiscal disaster. The policy changes, especially in the short run, cannot be limited to expenditure cuts, as exponents of the Tea Party have been demanding. Taxpayers, and especially those at the top, must bear some of the burden of the needed adjustment. The rest of the citizens must also bear some of the burden, over the medium and long run, when public spending could be reduced. See Tanzi, 2013.

Table 1 provides data for the United States, reported by the OECD, for different periods, for Gini coefficients, before taxes and transfers, and after taxes and transfers, and effective total tax rates on the taxable income of millionaires, reported by the (US) Tax Foundation. The trends are clear.

Table 1. Effective Tax Rates on Millionaires and Gini's in USA

<table>
<thead>
<tr>
<th>Period</th>
<th>Effective Tax Rates on Millionaires</th>
<th>Gini Before Taxes and Transfers</th>
<th>Gini After Taxes and Transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mid-70s</td>
<td>n.a.</td>
<td>0.406</td>
<td>0.316</td>
</tr>
<tr>
<td>Mid-80s</td>
<td>47.7 (1982)</td>
<td>0.436</td>
<td>0.337</td>
</tr>
<tr>
<td>Around 1990</td>
<td>n.a.</td>
<td>0.450</td>
<td>0.348</td>
</tr>
<tr>
<td>Mid-1990s</td>
<td>n.a.</td>
<td>0.477</td>
<td>0.361</td>
</tr>
<tr>
<td>Around 2000</td>
<td>36.4 (2000)</td>
<td>0.476</td>
<td>0.357</td>
</tr>
<tr>
<td>Mid-2000s</td>
<td>n.a.</td>
<td>0.486</td>
<td>0.380</td>
</tr>
<tr>
<td>Late 2000s</td>
<td>32.4 (2010)</td>
<td>0.486</td>
<td>0.378</td>
</tr>
</tbody>
</table>

Source: OECD and Tax Foundation.
5. SHOULD THE INCOME OF THE BIG BE PROTECTED?

In the question of whether the income of “the big” should be subjected to high marginal tax rates, there are some major issues that have attracted little attention, but that may be important. One is the relevance of the incentive question, which seems to attract much of the attention of economists. Another is whether the incomes that the high-income individuals receive truly reflects “what they deserve”, as measured by the genuine value of what they contribute to the economy and to the society.

The question of incentives, as seen by economists, was discussed earlier in this paper where references were made to various, mostly theoretical, studies that argued that high tax rates are likely to create disincentives to work, save, and invest, especially when the rates are high and, especially, for the propensity to work by second workers. Starting in the early 1990s some studies, have focused on the incentives that economic agents have in taking their capital, and occasionally even themselves, out of the country, and into lower-taxing countries, to reduce, or to avoid, the high taxes. These aspects have attracted growing attention in recent years, including at political meetings of the G7 and the G20 groups of countries.

Capital and especially financial capital can emigrate on a large scale, from high tax to low tax jurisdictions. Occasionally, high-income individuals who, because of their activities, are able to operate from different places, can also choose, and be able to move to, lower taxing countries. These individuals can use their skills and talent to continue operating from places where taxes are lower. The fact that some activities have become global, including those in the financial market, and that the internet facilitates contacts and transactions, among individuals located in different places, together with the existence of many low-tax, or even zero-tax jurisdictions, have encouraged some mobility by high income individuals.

Attempts to avoid taxes can involve different actions: (a) migration abroad; (b) migration toward leisure activities; and (c) migration toward underground or, explicit, tax evading activities, within the same countries. While a few decades ago the latter two possibilities attracted much of the attention, now, as a consequence of globalization, it is the first action that attracts a great deal of attention.

In the analysis of the impact of income taxes on the behavior of individuals, economists give most weight to the (highest) statutory, marginal tax rate, regardless of the level of income at which it is applied, and regardless of how many individuals are affected by it. However, not all the individuals who are subjected to income taxes are affected by the highest marginal tax rate. If that rate applies only at very high income levels, so that most taxpayers face lower rates on the last dollar that they earn, the disincentive effects of the (highest) marginal tax rates on the whole population of taxpayers would be much reduced.

There are a few countries in which most of the taxpayers are subjected to broadly proportional rates while a relatively small number of them, those with
very high incomes, the really “big”, face a much higher rate. When this happens, the potential disincentive effect of the high rates is limited to a numerically small, though economically important, share of the population. It could be argued that the extra revenue that is collected from the top income taxpayers, if it is used to reduce the marginal tax rates for the larger group that has lower incomes, might even increase the total incentives. It is the tax rate that applies at levels of income that most workers receive that may be particularly important, not the highest, marginal tax rate.

The current political rhetoric, especially in the United States, gives enormous importance to the small share of taxpayers who have the highest incomes. It is often repeated that these are the individuals who create jobs and promote growth. Therefore, they need to be protected against higher tax rates. This belief is not supported by any existing, formal, theory of economic growth, even though it is popular with many conservative Americans, and with members of the Tea Party, who keep repeating it at nauseam.

Another point to recognize is that the group of high-income taxpayers is a very diverse group, likely to have different motivations for working hard. This group includes top athletes, famous artists, highly successful professionals (doctors, lawyers, actors and writers, television personalities, architects, and others) and, of course, CEOs and financial market operators. It also includes some people whose income comes from inherited wealth. It would be strange if all these individuals responded in the same way to the incentives created by taxation.

Many of the people who make up the group of the very high incomes, “the big”, have achieved a level of success that has not only given them high incomes but also high social and professional statuses, or even fame, in the society in which they live. These statutes must give them pride and large “psychic incomes”. While high tax rates reduce the money incomes, they do not reduce the “psychic incomes”, as long as the effort and the social positions are maintained. It would be stretching reality, and it would require a crass sociological assumption, to believe that all these people respond, in a robot-like fashion, only to the money incentives and to nothing else, including the effects on their reputation. Few sociologists, or philosophers, or common citizens would share this view, a view that seems to be accepted acritically by many economists.

It seems highly unlikely that successful athletes, actors, artists, or professionals, that have reached a high social, or professional, status in their profession, would reduce their work and effort, and risk losing their privileged professional and social position, because the income that they receive, above some level, were taxed at higher tax rates. On the way to the top these individuals would not have faced the (highest) marginal tax rates, especially if the high rates were applied at a level of income that, for professionals and athletes, was high enough to imply that a high level of success has been achieved. The economists’ view of the behavior of these individuals puts these individuals in the position of mercenary, willing to give their best only in exchange for money. This is not a realistic, or complimentary, view of human nature and of how many individuals operate.
Obviously among the high income groups there are some whose motivation is, mainly, or only, money. What proportion these individuals constitute among the very high-income individuals, among “the big”, is difficult to tell. Recent developments and reports would suggest that these individuals are likely to be found mainly, or in larger proportions, within the financial and business community. Perhaps individuals with more money motivations tend to gravitate to these activities. Bankers, hedge fund managers, traders, and high-level managers of business enterprises are likely to dominate this group.

This takes us to the important and related issue of whether the incomes that the very highly-compensated individuals receive for their market participation can always be assumed to reflect “what they deserve”, because of the value that they contribute to national income. The sanguine view of the operations of a market and especially of the financial market economy, that is used to justify the incomes of the individuals who operate in it, regardless of what they do, is a view that requires “blinds” and a “suspension of disbelief” to be accepted, especially after the series of scandals that have been reported almost daily in recent years in leading financial newspapers.

In recent years the financial market has been rocked by reports of enormous abuses that included, but were not limited to, those connected with the sub-prime disaster that plunged the world into the “Great Recession”. The reports included: Ponzi schemes, insiders trading, manipulation of and promotion of faulty information, etc. The sub-prime disaster has been followed by the still evolving Libor scandal. The above were not rare individual failures but frequently they represented systemic failures of the operation of the market. These abuses had often created huge incomes for some of the people involved, and in many cases had generated large costs for the society at large. Libor had been a benchmark for a $360 trillion market in mortgages, credit cards and other contracts in the world. It had played a major role in determining or justifying the high incomes of “the big”. The same was the case with the insider trading cases.

The abuses in Libor were perpetuated with the implicit cooperation of accounting firms and even of central banks. Robert Diamond, who received $186 millions in salary, benefits and bonuses since 2005 and who was the CEO of Barclays, the bank at the center of the Libor scandal, claimed to be unaware of what the traders in his bank were up to. One wonders what justified his compensation if he were telling the truth. It seems that underlings make “mistakes”, CEOs do not, and are therefore not responsible for the mistakes made by their underlings! In another area, Glaxo Smith Kline in the pharmaceutical sector, was fined $3 billion for misleading the public on the effects of some drugs. These misleading actions, that seem to have become more frequent in recent years, must also have earned high incomes for some “big”.

In recent years there have been so many abuses and acts of corruption reported daily, by newspapers such as The Financial Times, The Washington Post, The New York Times and other newspapers that these newspapers could legitimately change their names to The Corruption Times, the Corruption Post...
and other similar names. The bottom line is that, slowly or perhaps not so slowly, “market capitalism” is becoming “crony capitalism”, where whom you know, and what access you have to connections, and to what could be described as “institutional capital,” is what determines, in many areas of activity, success and incomes. It can be concluded that for different reasons, for both, those at the bottom and those at the top of the income distribution, it would be a stretch of reality to conclude that they “get what they deserve”.

This worrisome transformation of the market system raises valid questions as to whether the incomes of the big should be protected against high taxes, on the grounds that “they get the incomes that they deserve” and that they are the “people who create jobs and employment”. As an example, when Tony Blair, the former British Prime Minister joined the board of J.P. Morgan International, he was paid $2.5 million a year (sic), to give “strategic advice” to senior clients and to the bank’s board. Reported by The Financial Times, June 30, 2012, Life and Arts Section, p. 1. It is obvious that what Blair provided were “connections” that are highly useful in “crony capitalism”.

The connections and the set of rules that make possible and protect some high incomes (patents, copywrites, trademarks, difficult access to some activities, complex rules that can be interpreted to favor some groups, use of lobbyists, etc.) have created an “institutional capital” that some individuals can use far more easily than others. The revolving doors that often exist between sensitive government agencies (regulatory agencies, patent office, tax administration, the military establishment, and so on) and private sector’s high level jobs facilitate the work of “crony capitalism”. There is no equality of opportunity in “crony capitalism” as it would exist in a truly efficient market economy.

The institutional capital has created, for some individuals, situations that can be described by the general rule of “head I win, tail you lose” This rule applies to executive compensation and to the compensation of hedge funds’ managers and CEOs of large companies. An idea of the operation of the above rule is provided by Table 2, which reports for five large banks the total pay in 2011 of selected CEOs against the change in the banks’ share prices. It would be difficult to argue that the pays received by the individuals reported in the table reflect what these individuals deserve on the basis of the value that they created in the economy. It would be easier to argue that the growth in the productivity of workers in corporations has been increasingly diverted to the benefit of the managers. Workers and shareholders are likely to have been the losers.
Table 2. Total Pay in 2011 and Performance of Bank Share Price (in millions of US $ and Percentage change)

<table>
<thead>
<tr>
<th>Individuals</th>
<th>Total Pay</th>
<th>Change in Bank Share Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jamie Dimon (J. P. Morgan)</td>
<td>23.1</td>
<td>- 21/6</td>
</tr>
<tr>
<td>Bob Diamond (Barclays)</td>
<td>20.1</td>
<td>- 32.7</td>
</tr>
<tr>
<td>John Stumpt (Wells Fargo)</td>
<td>17.9</td>
<td>- 11.1</td>
</tr>
<tr>
<td>Llyod Bankfein (Golman Sachs)</td>
<td>16.2</td>
<td>- 46.2</td>
</tr>
<tr>
<td>Alfredo Saenz (Banco Santundes)</td>
<td>16.1</td>
<td>- 23.3</td>
</tr>
</tbody>
</table>


An extended survey of “Executive Pay” produced by Equilar Inc., for 2011, was published by The New York Times, on June 17, 2012. The survey shows the extraordinary compensations for 200 CEOs in what was supposed to be a crisis year and when unemployment was very high. The average compensation for this group was $19.8 million. It had increased by 20 percent since 2010. Those just below the CEO level did equally well. The lady that was fired by J.P. Morgan, for losing, in bad trade, about $6 billions to the Bank, the previous year, 2011, had earned $15 million.

There is growing evidence that high compensation and especially large bonuses to executives do not necessarily make enterprises, and especially banks, more competitive. For example, it has been reported that some of the world’s safest and most profitable banks (in Sweden and in the Netherlands) do not pay bonuses. See the article by Leonid Bershidsky, in Bloomberg News, October 18, 2013. Therefore, the argument that taxes on high incomes must be kept low in order not to reduce incentives loses some of its legitimacy. At the same time, it cannot be denied that some of the forces created by globalization may have imposed limits to the tax rates that can be levied on some sources of income.

6. Taxing the Big in Developing Countries

Many of the issues discussed in this paper in connection with the USA have relevance for most countries including developing countries. However, some distinguishing features of developing countries’ economies call for specific comments. There are some major differences between a typical developing country’s economy and a typical advanced country’s economy.

In the first place developing countries tend to have income distributions that are much less even than advanced countries. This means that the top percentiles of the income distribution contain more potential taxing capacity than in advanced countries.

In the second place these countries tend to have far more informality in their economies than the advanced countries. This increases the difficulties of extracting high tax revenue from the middle and the lower income classes.
Third, the administrative capacity of the tax administrations of these countries is generally more limited than that of advanced countries.

Fourth, the individuals at the top of the income distribution tend to have more political power and to be better integrated globally than those in advanced countries. They have often studied abroad and many have married foreign spouses.

Fifth and most important, there is a very large difference in the shares of national income that goes to labor versus the share that goes to capital, between developing and advanced countries. Broadly speaking, the share that goes to labor is much smaller in developing countries than in advanced countries. This share is often less than 30 percent, in developing countries, and over 60 percent, in advanced countries. This means that to get a significant level of tax revenue, the developing countries need to rely more than the advanced countries on the taxation of non-labor income sources, such as consumption and incomes from capital. On average, corporate income taxes contribute more taxes in developing countries than in advanced countries. Other taxes on capital incomes seem to contribute much less.

Capital mobility and the political power of the elite in developing countries have made it difficult to impose high tax rates on the incomes of the rich. Taxes on real property, including land and houses, have provided little revenue. In developing countries much attention has been directed at tax evasion and not enough at the tax laws that have, generally, favored excessively the high income groups. As these countries become more urbanized and as the increase of human capital makes the income of labor go up, the differences between developing countries and advanced countries will become less accentuated. In the meantime more effort should be made at making the laws less favorable to the rich, in spite of the concerns about incentives.

Finally, a word of caution may be needed. The view that, to develop and grow, governments need more revenue must always be qualified by a discussion of the use of tax revenue. If revenues are used inefficiently, the arguments for high tax levels lose some of their validity. But even in these circumstances it is preferable to try to collect the taxes in as equitable a way as possible. The inefficient and inequitable collection of taxes produces the worst of the possible world.

REFERENCES