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Confusing Wealth and Income

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Which of the following families is "richer"? The first family consists of a wife who has recently become a medical doctor, and she makes $160,000 per year. Her husband is a small business entrepreneur who makes $110,000 per year, giving them a total family income of $270,000 per year. However, they are still paying off the loans the wife took out for medical school and the loans the husband took out to start his business, amounting to debts of $300,000. Their total assets are valued at $450,000; hence, their real net worth or wealth (the difference between gross assets and liabilities) is only $150,000.

The second family consists of a trial lawyer who took early retirement and his non-working wife. They have an annual income of $230,000, all of it derived from interest on tax-free municipal bonds they own. However, their net worth is $7 million, consisting of $5 million in bonds, a million-dollar home with no mortgage, and a million dollars in art work, home furnishings, automobiles and personal items.

The second family is clearly far better off financially than the first family, yet many in the U.S. Congress, including Sen. Barack Obama, want to increase taxes on the first (and poorer) family and not on the wealthier family. They have mis-defined "rich" by confusing a flow (income) with a stock (real net assets), and thus come to the wrong conclusion. They want to tax those (who make more than $250,000 a year) who are trying to become rich, while preserving the status for those who already have wealth.

Increasing taxes on those 2.3 million American households who earn more than $250,000 per year is foolish and destructive for several reasons. It reduces the incentives for highly productive people to spend years in school obtaining needed skills, and then work hard in producing goods and services desired by their fellow citizens. It encourages the misallocation of productive resources by encouraging people to find ways to minimize the tax burden rather than to use their labor and savings for the highest and best use. It reduces the mobility of families up and down the income scale, and freezes the advantages of those who have substantial inherited wealth (e.g., the Kennedys, Kerrys, Pelosis, etc.).

Those who want the "rich" to pay more or "give back" not only confuse income with wealth, but also fail to understand life cycle mobility, and the effects of taxation and income redistribution programs on "disposable income." Many people, when they are young (including the average graduate student), would be classified as poor in terms of taxable income. Most people have a sharp rise in family or "household" income after they graduate from school, and many of these enter the definition of "upper income" in their forties and fifties, but after they retire, their taxable income often drops to the point where they are considered middle income, even though they may have more than a million dollars in net assets. Income distribution is most often defined by "household" income as contrasted with individual income. Most low-income "households" consist of single (often young) individuals, while most families with more than one income earner are higher income "households." The fact is there are about 4 times (8.9 million) as many households that have net assets of a million or more than there are households that earn more than $250,000. And many of the high-income households do not have a million dollars in net assets.

Many politicians and media people confuse taxable income with disposable and in-kind income. Because of the highly progressive income tax system, (97 percent of income taxes are paid by the top 50 percent of income earners and the top 1 percent pays 40 percent of the tax, despite having only 20 percent of the income), the difference in high-income and low-income families in after-tax income is far less than pre-tax income. In addition, there are many government welfare and subsidy programs for low-income people that are not included in many of the standard definitions of income.

Given that high marginal tax rates on income are counterproductive, some have argued for a wealth tax, but that doesn't work either. A wealth tax mainly taxes productive capital, thus reducing job and productivity growth, and it also encourages people to move their wealth to other countries and/or engage in extravagant expenditures - as the French have found out, much to their regret.

Mr. Obama also says that he wants to increase the capital gains tax. Many people have times in their lives when they reap a substantial capital gain from the sale of a farm or small business or a vacation home, etc. If they receive a couple of hundred thousand dollars or more from the capital gain, they appear to be "rich" in that year, according to Mr. Obama's definition, even though they may have an average yearly income of less than $100,000 and net assets of less than a half-million dollars. They will not only be taxed at a higher rate, but if the asset has been held for many years and has grown in value no faster than inflation, they will be taxed on imaginary income, and may well suffer a real loss - which is not only economically destructive but immoral.

Those who confuse taxable income with wealth are guilty of both sloppy use of language and sloppy thinking. Is it prudent to trust the writing of the tax code to a group of sloppy thinkers?

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