

It is settled political doctrine in the United States that our tax system should achieve vertical and horizontal equity. That is, those who have more should pay more and those who have the same should pay the same. Our tax code is a failure on both counts. How can it be changed? Who should pay more? Who should pay less?

Tax fairness, like beauty, is in the eye of the beholder. But fairness in our tax system is not about the concept of fairness, but rather about manipulation of the tax system for the benefit of certain groups and individuals. The left pleads for more "taxes on the rich." The right pleads that they are over taxed and already pay a disproportionate share of taxes. What is a workable, politically viable solution?

"Taxes on the rich" is a handy political phrase, but what does it mean? Judging from Teresa Heinz Kerry's tax return, we could raise top tax rates to the moon, and I suspect she would pay little additional taxes. Why is that? The difference is the basis of taxation. Our system is based on transactional income. If there is an economic event, we can dream up some way to tax it. If you are very rich, you have little need for a high current income. A few million dollars in income will more than cover family needs, so you will simply arrange your affairs so that they produce very few taxable transactions. You will probably also arrange your affairs to take very little risk, thereby preserving your vast wealth.

If you are very rich, what are the tricks for avoiding taxable income? There are just too many to count let alone list here. These devices range from tax free municipal bonds, to various tax-exempt trusts and foundations, to tax free off-shore trusts and businesses. For those transactions that can't be avoided, there is a world of tax avoidance schemes that defer income or convert it to lower tax rates.

When John Kerry advocated raising taxes on those who earn over \$200,000 per year, who really pays those taxes? On a proportionate basis, it is certainly not the very rich. The people who pay those taxes are the professionals and entrepreneurs who have several degrees and work 60-80 hours per week. They typically need all of their income to support a rapidly improving lifestyle. And because many of these individuals are W-2 wage earners, they have limited flexibility to reduce their taxable income, especially as the Alternative Minimum Tax ensnares more and more of them. These are the creative hard-working people who generate most of the jobs and new wealth in the country. Do we really want to tax them to death?

The right makes the point that the top 10% of taxpayers pay 50% of the taxes. But the top 1% of payers are in a class by themselves. They hold nearly 40% of the country's wealth yet they report only 13% of before tax income. With our graduated system they should be taxed on a much larger income base. Teresa's estate is worth an estimated \$1 billion, yet she reported only \$6.8 million in income last year. Does anybody really

believe that that estate of this size produced a return of less than 1%? And it paid less than 13% average tax on the meager income reported.

Properly done, tax reform can lower rates on about everybody except the top 1%. But the tax preferences and exceptions are deeply embedded in our system, and there's a strong constituency behind every one of them. The very rich have exploited them to great advantage. Coincidentally, these same people provide most of the political contributions that elect our politicians.