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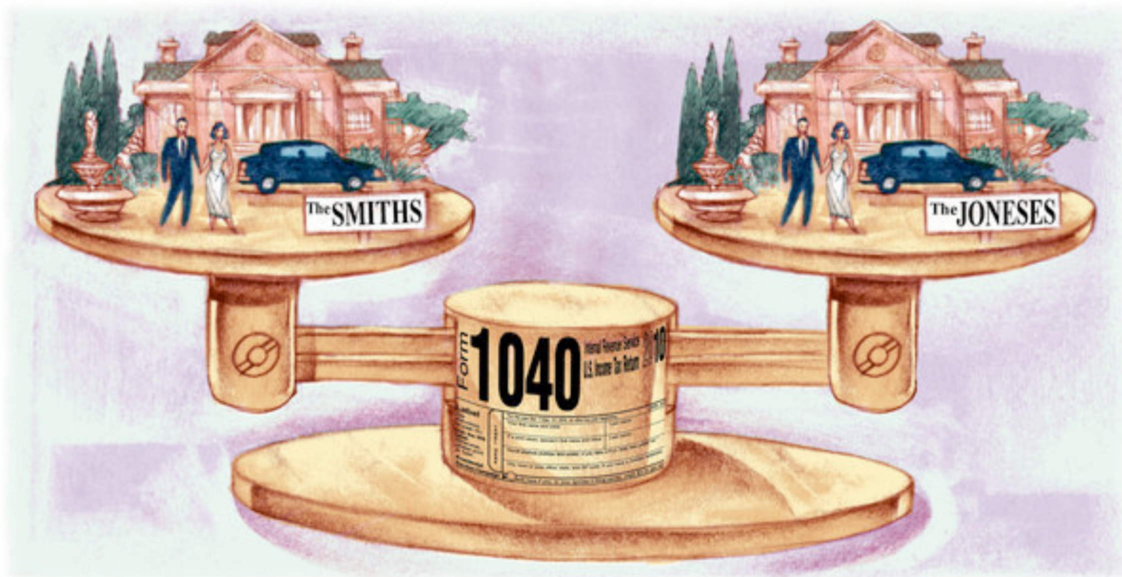
Taxing the Rich: It's All Relative

By ROBERT H. FRANK



IT'S not just Tea Party activists who are angry about taxes. A much larger and more diverse group appears outraged that Congress is considering allowing the Bush tax cuts to expire at year-end for families earning more than $250,000 and for individuals earning more than $200,000.

A financially prosperous friend of mine is a case in point. He watches a lot of angry talking heads on cable news, and he recently buttonholed me to ask whether I had any idea that our taxes were about to rise. Did I know that the president was not only planning to allow the Bush tax cuts to expire for relatively high-income people like us, but that he was also thinking of raising the ceiling for the payroll tax? Did I know that we might also face increases in Medicare and self-employment tax rates? And that taxes in New York State could go up, too? His face grew redder as he listed each outrage.

I said I knew all about the scheduled expiration of the Bush tax cuts but hadn't heard much about the other proposals. When he expressed shock that I hadn't, I tried to explain why I didn't think it made sense to fret.

First, I said that with baby boomers entering retirement, there's no way that spending cuts alone could prevent federal debt from spiraling out of control. We also need additional revenue. Of course, there are many complex issues in weighing the effects of even a modest increase in top tax rates. (Would it reduce economic growth, for instance? There's no credible evidence that it would.)

But the most salient issue in taxpayers' minds is how the changes would affect their own standard of living. Truly wealthy families wouldn't have to alter their spending at all. Neither my friend nor I is in that league, but we've both saved a lot and could easily maintain our current spending levels even if the president's proposals were adopted.

Many families with income of $250,000 and more do spend everything they earn, and, of course, would have to cut back. As psychologists have long known, individuals typically find belt-tightening painful. But recent psychological research suggests that if all in that group spent less in unison, their perceptions of their standard of living would remain essentially unchanged.

That's because once consumers move out of the realm of necessities, they focus on what the late British economist Fred Hirsch called positional goods — things that stand out from the ordinary, or whose value stems largely from the fact that not everyone can have them. Homes with spectacular views are an example, as are high-performance cars, designer clothes and gourmet meals. A modest increase in top tax rates would not compromise prosperous families' abilities to enjoy such pleasures.

Consider a hedge fund manager who wants an apartment with a sweeping view of Central Park. Because the supply of such apartments is limited, he must outbid others who also want one. If his tax rate rises, he won't be able to bid as much as before. But because others' tax rates will also climb, they won't be able to bid as much, either. So the tax increase, if it applies to all bidders, will not affect the outcome.

With less after-tax income, top earners also wouldn't be able to spend as much on cars or their children's weddings and coming-of-age parties. But why did they feel compelled to spend so much in the first place? In most cases, they simply wanted a car that felt spirited, or a celebration that seemed special. But concepts like “spirited” and “special” are inescapably relative: when others in your circle spend a lot, you must spend accordingly or else live with the disappointment that results from unmet expectations.

If the top tax rate were to rise, as scheduled, from 35 percent to 39.5 percent — its level during the Clinton era — many top earners would spend a little less on cars and parties, so the standards that define their expectations would adjust. But once the dust settled, their cars would feel no less spirited, and their celebrations no less special, than before.

In short, letting the Bush tax cuts for the most prosperous families expire next month would hardly hamper their ability to buy what they want.

The resulting revenue, however, could do a lot of good for our struggling economy. In the short term, it could be used for grants to state and local governments, which have been forced by their own revenue shortfalls to lay off hundreds of thousands of workers. And in the long term, it could help address legitimate concerns about burgeoning federal deficits.

I EXPLAINED all of this to my friend — telling him that because the tax increases he listed would apply not only to him and me, but also to others like us, they wouldn't much affect our ability to acquire the things we want. That seemed to calm him down a bit.

If more people thought about the issue in these terms, there might be less anger and unhappiness in the land. And sensible, pragmatic solutions to our most pressing economic problems might be less likely to be rejected as politically unthinkable.

Robert H. Frank is an economics professor at the Johnson Graduate School of Management at Cornell University.