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The Soak-the-Rich Catch-22

By ARTHUR LAFFER

Tax reduction thus sets off a process that can bring gains for everyone, gains won by marshalling resources that would otherwise stand idle—workers without jobs and farm and factory capacity without markets. Yet many taxpayers seemed prepared to deny the nation the fruits of tax reduction because they question the financial soundness of reducing taxes when the federal budget is already in deficit. Let me make clear why, in today's economy, fiscal prudence and responsibility call for tax reduction even if it temporarily enlarged the federal deficit—why reducing taxes is the best way open to us to increase revenues.

—President John F. Kennedy,
Economic Report of the President,

January 1963

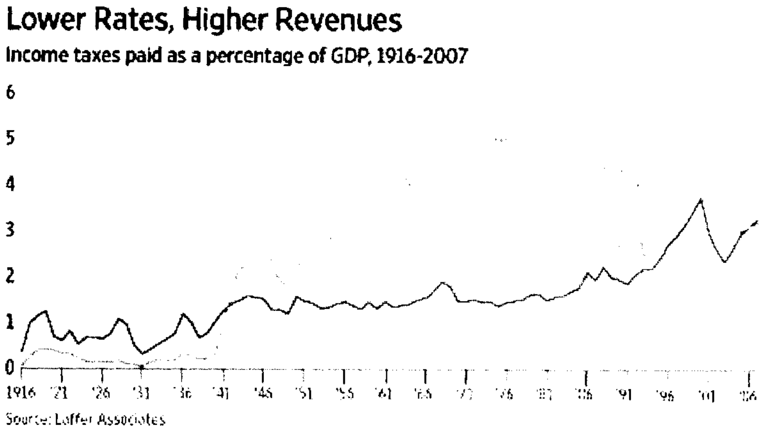
If only more of today's leaders thought like JFK. Sadly, in the debate over whether to extend the 2001 and 2003 tax cuts, and if so whether the cuts should be extended to those people who are in the highest tax bracket, there is a false presumption that higher tax rates on the top 1% of income earners will raise tax revenues.

Anyone who is familiar with the historical data available from the IRS knows full well that raising income tax rates on the top 1% of income earners will most likely reduce the direct tax receipts from the now higher taxed income—even without considering the secondary tax revenue effects, all of which will be negative. And who on Earth wants higher tax rates on anyone if it means larger deficits?

Columnist Kimberley Strassel discusses Nancy Pelosi's plan to have a tax vote before November, and OpinionJournal.com assistant editor Allysia Finley reports on the battle to reform state spending.

Since 1978, the U.S. has cut the highest marginal earned-income tax rate to 35% from 50%, the highest capital gains tax rate to 15% from about 50%, and the highest dividend tax rate to 15% from 70%. President Clinton cut the highest marginal tax rate on long-term capital gains from the sale of owner-occupied homes to 0% for almost all home owners. We've also cut just about every other income tax rate as well.

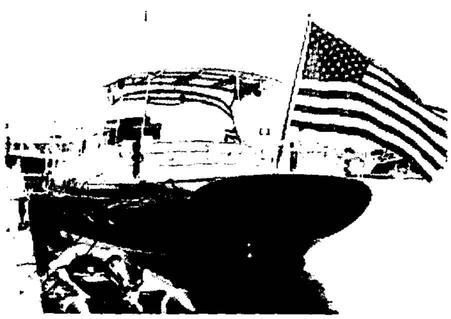
During this era of ubiquitous tax cuts, income tax receipts from the top 1% of income earners rose to 3.3% of GDP in 2007 (the latest year for which we have data) from 1.5% of GDP in 1978. Income tax receipts from the bottom 95% of income earners fell to 3.2% of GDP from 5.4% of GDP over the same time period. (See the nearby chart).



These results shouldn't be surprising. The highest tax bracket income earners, when compared with those people in lower tax brackets, are far more capable of changing their taxable income by hiring lawyers, accountants, deferred income specialists and the like. They can change the location, timing, composition and volume of income to avoid taxation.

Just look at Sen. John Kerry's recent yacht brouhaha if you don't believe me. He bought and housed his $7 million yacht in Rhode Island instead of Massachusetts, where he is the senior senator and champion of higher taxes on the rich, avoiding some $437,500 in state sales tax and an annual excise tax of about $70,000.

Howard Metzenbaum, the former Ohio senator and liberal supporter of the death tax, chose to change his official residence to Florida just before he died because Florida does not have an estate tax while Ohio does. Goodness knows what creative devices former House Ways and Means Chairman Charlie Rangel has used to avoid paying taxes.


Associated Press

The stern of John Kerry's yacht

In short, the highest bracket income earners—even left-wing liberals—are far more sensitive to tax rates than are other income earners.

When President Kennedy cut the highest income tax rate to 70% from 91%, revenues also rose. Income tax receipts from the top 1% of income earners rose to 1.9% of GDP in 1968 from 1.3% in 1960. Even when Presidents Harding and Coolidge cut tax rates in the 1920s, tax receipts from the rich rose. Between 1921 and 1928 the highest marginal personal income tax rate was lowered to 25% from 73% and tax receipts from the top 1% of income earners went to 1.1% of GDP from 0.6% of GDP.

Or perhaps you'd like to see how the rich paid less in taxes under the bipartisan tax rate increases of Presidents Johnson, Nixon, Ford and Carter? Between 1968 and 1981 the top 1% of income earners reduced their total income tax payments to 1.5% of GDP from 1.9% of GDP.

And then there's the Hoover/Roosevelt Great Depression. The Great Depression was precipitated by President Hoover in early 1930, when he signed into law the largest ever U.S. tax increase on traded products—the Smoot-Hawley Tariff. President Hoover then thought it would be clever to try to tax America into prosperity. Using many of the same arguments that Barack Obama, Nancy Pelosi and Harry Reid are using today, President Hoover raised the highest personal income tax rate to 63% from 24% on Jan. 1, 1932. He raised many other taxes as well.

President Roosevelt then debauched the dollar with the 1933 Bank Holiday Act and his soak-the-rich tax increase on Jan. 1, 1936. He raised the highest personal income tax rate to 79% from 63% along with a whole host of other corporate and personal tax rates as well. The U.S. economy went into a double dip depression, with unemployment rates rising again to 20% in 1938. Over the course of the Great Depression, the government raised the top marginal personal income tax rate to 83% from 24%.

Is it any wonder that the Great Depression was as long and deep as it was? Whoever heard of a country taxing itself into prosperity? Not only did taxes as a share of GDP fall, but GDP fell as well. It was a double whammy. Tax receipts from the top 1% of income earners stayed flat as a share of GDP, going to 1% in 1940 from 1.1% in 1928, but at what cost?

We all know that there are lots of factors influencing tax revenues from the rich, but the number one factor has to be the statutory tax rates government tells the rich they have to pay. Not only do the direct income tax consequences of higher tax rates on those in the highest brackets lead to higher deficits, the indirect effects magnify the tax revenue losses many fold.

As a result of higher tax rates on those people in the highest tax brackets, there will be less employment, output, sales, profits and capital gains—all leading to lower payrolls and lower total tax receipts. There will also be higher unemployment, poverty and lower incomes, all of which require more government spending. It's a Catch-22.

Higher tax rates on the rich create the very poverty and unemployment that is used to justify their presence. It is a vicious cycle that well-trained economists should know to avoid.

Mr. Laffer is the chairman of Laffer Associates and co-author of "Return to Prosperity: How America Can Regain Its Economic Superpower Status" (Threshold, 2010).

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