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THE ONSLAUGHT FROM THE LEFT, PART II: PRESIDENTIAL POLITICS

By Arthur B. Laffer and Ford M. Scudder

Summary

- The leading Democratic presidential candidates propose raising tax rates on the rich and reducing tax rates on lower and middle income earners. These policies would have disastrous consequences.
- Using logic, economics, and history as a guide, it is clear that implementing these policies would lead to revenues far short of expectations due to both deadweight revenue losses from those in the lower tax brackets and the effects of supply-side responses from those in the highest tax brackets.
- Furthermore, these anti-growth policies would lead to a prolonged economic downturn, a reduction in the value of U.S. assets, a weaker dollar, decreased U.S. competitiveness, and a fiscal catastrophe.

"Reagan changed the trajectory of America in a way that Richard Nixon did not and in a way that Bill Clinton did not. He put us on a fundamentally different path because the country was ready for it."

"I think it's fair to say that the Republicans were the party of ideas for a pretty long chunk of time there over the last 10 to 15 years in the sense that they were challenging conventional wisdom."

-Barack H. Obama

It is becoming clearer and clearer that, if elected, the Democrats intend to raise tax rates on the so-called "rich" and at the same time use those proceeds to lower tax rates on middle and lower income earners. The taxes to be raised are the highest rates on the personal income tax, capital gains tax, dividend tax, corporate income tax and inheritance tax. In its simplest form, the Democrats intend to allow Bush's tax cuts to expire, thereby pushing the highest tax rates back up to where they were prior to Bush's tax cuts.¹

If successful in effectuating their agenda, the Democrats will be bitterly disappointed in their expectations of tax revenue. As collateral damage, they will cause the poor to become poorer right along with the rich becoming poorer. A more even distribution of income will bring with it lower incomes for all.² Let's go through the logic step by step and then review the evidence.

I. The Logic

Save for sin taxes, where one of the benefits of a tax increase is an actual diminution of the activity itself, there is no logic to raising a tax rate if the actual revenues collected decline. By raising the tax rate, those people who engage in the activity are unambiguously worse off and at the same time beneficiaries of government programs are also worse off as a result of diminished tax revenues. No one of good intentions would ever advocate such a tax increase if the facts were as we described them.

A. On the Margin

All income earners in the highest income tax bracket face the highest income tax rate as their marginal tax rate. It is this highest marginal tax rate that influences the very highest income earners' behavior whether to work more, invest more, move to a preferable location or engage the services of tax lawyers, accountants, etc. In some cases it could be this rate that

¹ Under the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and Tax Increase Prevention and Reconciliation Act of 2005, on January 1, 2011 the top marginal income tax rate will increase from 35% to 39.6%, the top tax rate on dividends will rise from 15% to match tax rates on standard income, the top tax rate on capital gains will increase from 15% to 20%, and the top tax rate on inheritance will increase from 45% (and 0% in 2010) to 55%.

² For a conceptual and empirical framework on this issue, see Arthur B. Laffer, "The Onslaught from the Left, Part I: Fact vs. Fiction," Laffer Associates, October 31, 2007.

pushes someone into illegal activities. In fact, back in the 1970s, the world renowned liberal Swedish economist and Nobel laureate Gunnar Myrdal bemoaned the fact that the progressive income tax in his country had created such strong incentives as to turn normally law abiding, rule-following Swedes—especially those with high incomes—into tax avoiders and, in some cases, even outright tax evaders, without redistributing income as was promised.³

Whatever the actual consequences, it is important to understand that people make their decisions based on their highest marginal tax rate, not their average or lowest tax rate. In the highest income tax bracket everyone—100% of all income earners—faces the same marginal tax rate, which is the highest rate.

But the highest income earners also pay the lowest bracket's and middle brackets' tax rates in addition to the highest tax rate. If you go back to your income tax return (Form 1040) you can see that for the first category of income your tax liability is based on the lowest tax rate, and then incrementally you add the tax liability from the second lowest category of income and its tax rate, and so on until you come to the highest tax category, which is unbounded. For this last category, you take all of your additional income above the sum of the incomes in all the lower categories and calculate your additional tax liability using the highest tax rate. If the lower tax rates are increased, higher income earners will unambiguously pay more taxes, and if the lower tax rates are reduced, higher income earners will for sure pay less. It's as simple as that.

The important point here is that while all people in the highest income category base their decisions on the highest tax rate, they too pay taxes in each and every lower income category. For those people in the highest tax bracket, the tax rates applicable to the lower income tax categories are what we economists call inframarginal tax rates and do not affect behavior. For high income earners, changes in the tax rates applicable to lower income tax brackets will have revenue consequences but no behavioral consequences.

From this it should be easy to see that as we go from the highest income category to the lowest income category, more and more people pay the lower category's marginal tax rate and yet their behavior is not influenced by this tax rate (Table 1). As a result, cutting lower income categories' tax rates will create greater and greater deadweight revenue losses for the government and yet will influence less and less people's decisions to increase the amount of taxable income through output responses.

Table 1
2005 Tax Filers by Tax Bracket

Highest Tax Rate	Number of Tax Returns	Percentage of All Filers Paying This Rate	Percentage of Filers Paying This Rate for Whom it is the Marginal Rate
5%	1,186,478	100%	1.14%
8%	651	98.86%	0.00%
10%	25,508,822	98.86%	24.73%
15%	49,321,395	74.41%	63.54%
20%	2,960	27.13%	0.01%
25%	21,996,816	27.13%	77.72%
28%	3,730,002	6.04%	59.17%
33%	1,479,592	2.47%	57.48%
35% ¹	1,094,617	1.05%	100%

¹ This category also includes 141,612 tax returns of people who use form 8615 which includes the Alternative Minimum Tax and the associated tax returns of people 18 and under who pay tax rates in their parents' bracket.

Source: IRS, Statistics of Income

Lowering the lowest bracket's tax rates, because there are no supply-side effects from people who are in higher tax brackets yet pay taxes at the lower rates, will unambiguously lower these peoples' tax payments and thus will reduce this portion of the tax receipts to the federal government. Cutting tax rates in ever lower tax brackets will increasingly result in revenue losses without corresponding output responses, whereas raising tax rates in the highest tax bracket will result in universal negative taxable income responses.

B. The Incentive Effects

People don't work to pay taxes; people work to earn what they can after tax. It's this very personal and private incentive that motivates people to give up leisure in order to work, change jobs, get more education, invest their capital, take risk, etc. Likewise, people don't save to go bankrupt; they save to make an after-tax rate of return on their savings. It's the after-tax incentive that is instrumental in determining America's capital stock and the composition of our capital stock. With respect to

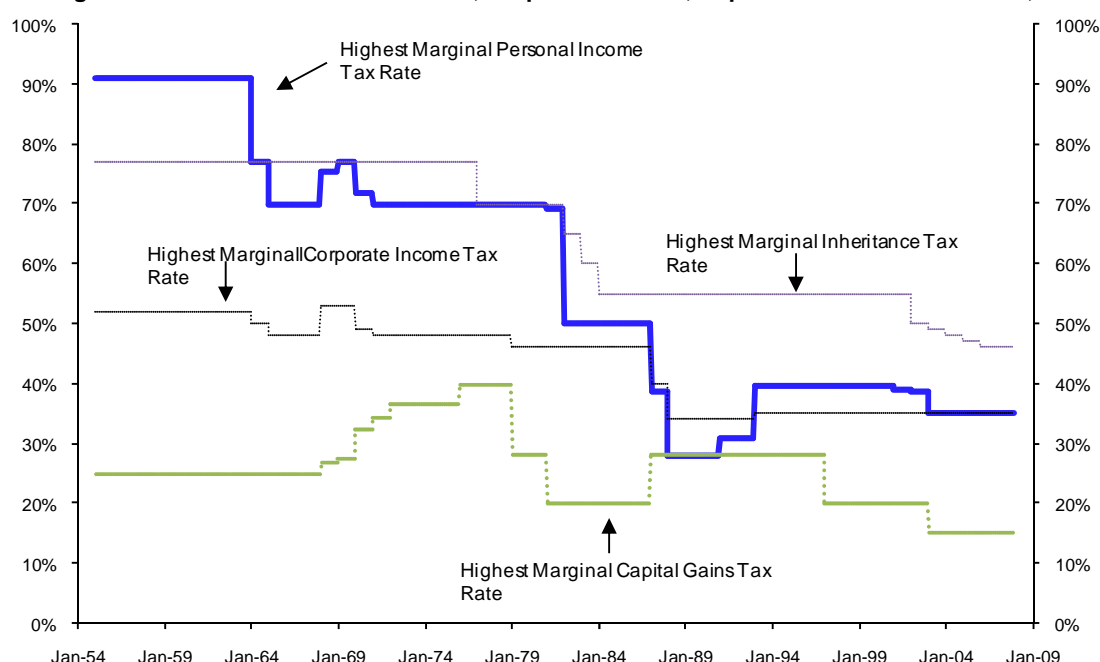
³ See Slemrod, Joel, "Tax Policy in the Real World," p. 332. See also Myrdal, Gunnar, "Time for a New Tax System" in *Ekonomisk Debatt* 6, November 1978, pp. 493-506.

the location of our capital stock, it is also true that businesses don't locate their plant facilities as a matter of social conscience. Businesses locate their plant facilities to make an after-tax rate of return for their shareholders.⁴

Again, in all of these instances it's the marginal after-tax rate of return that determines peoples' behavior, not tax rates. Now clearly marginal tax rates influence after-tax rates of return, but marginal tax rates are not one and the same as the after-tax rates of return. To see what we're driving at, we'll use an example of a time sufficiently far in the distant past where people will remember the events but where the political passion has long since subsided.

When John F. Kennedy took office as President of the United States in January of 1961, the highest federal marginal personal income tax rate was 91% and the lowest federal marginal personal income tax rate was 20%. As President, he proposed, among other things, to cut the highest tax rate from 91% to 70% and the lowest tax rate from 20% to 14% (see Figure 1). He succeeded. But to see how these tax rate cuts differentially affected after-tax incentives is crucial to understand how taxes work today.

Figure 1
Highest Marginal Tax Rates on Personal Income, Corporate Income, Capital Gains and Inheritance, 1955-Present



Source: IRS, Statistics of Income

Cutting the highest tax rate from 91% to 70% represents a 23% cut in tax rates ($21/91$). If there were no supply-side responses, i.e. everyone earned the same after the tax cut as they had earned before the tax cut, this would have resulted in 23% less tax revenues to the government from the highest tax bracket.

Using the same logic, the cut in the lowest tax rate from 20% to 14% would have reduced tax receipts in that tax bracket by 30% ($6/20$) if there had been no supply-side responses. But of course, the whole purpose of cutting tax rates is to trigger supply-side responses.

In the highest tax bracket, the key to the supply-side response rests on after-tax incentives. If prior to Kennedy's tax cut a person in the highest tax bracket earned one additional dollar before tax, then he would have 91¢ in additional taxes and would be allowed to keep 9¢. This 9¢ was the person's incentive for earning the additional dollar.

After Kennedy's tax cuts, however, if the same person earned the same additional dollar, instead of paying 91¢ in taxes, he would only have to pay 70¢ in taxes and would be allowed to keep 30¢ after tax instead of 9¢. The person's incentive for earning that same additional dollar would have risen from 9¢ to 30¢, or a 233% increase in incentives ($21/9$) for a 23% tax rate reduction. This represents a 10:1 benefit-cost ratio ($233/23$) in the highest tax bracket.

⁴ Arthur B. Laffer and Stephen Moore, *Rich States, Poor States: ALEC-Laffer State Economic Competitive Index*, The American Legislative Exchange Council, 2007. www.alec.org.

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In the lowest tax brackets, the incentive effects are very, very different than they are in the highest tax bracket. Not only are a lot less people working on the margin in the lowest tax bracket (as described in A. On the Margin), but even for those who are on the margin, the incentive increases emanating from a tax rate cut are a lot less than are the incentive increases in the highest tax bracket.

If a worker on the margin in the lowest tax bracket were to earn an additional dollar pre-tax, the additional tax liability would be 20¢ before Kennedy's tax cut and 14¢ after Kennedy's tax cut. The worker would have been able to keep 80¢ as an incentive before the tax cut and 86¢ after the tax cut. This represents a 7.5% increase in incentives (6/80) for a 30% cut in tax rates, even if we assume everyone in the lowest tax bracket were working on the margin—which they aren't. This is a 1:4 benefit-cost ratio (7.5/30).

When you compare the 10:1 benefit-cost ratio of a tax cut in the highest tax bracket to the 1:4 benefit-cost ratio in the lowest tax bracket, it elevates the supply-side incentive effect to its stark reality. Using these figures, there was a 40-fold increase in incentives in the highest tax bracket versus the lowest tax bracket per dollar of static revenue loss when Kennedy cut tax rates. Is it any wonder why we question the revenue assumptions used by the Democratic politicians of cutting the lowest tax rates while raising tax rates on the rich? We didn't just fall off a turnip truck.

Now clearly using just federal personal income tax rates today, the extreme results of the example used above for President Kennedy's tax cut would be greatly weakened. But don't delude yourself into thinking the differences are negligible today just because they may not be as large as they were in the early 1960s. The principle is still the same: the lower tax rates are, the less will be the incentive effect for any given tax rate change.

As we will see later, the actual taxes paid by the highest tax bracket filers are rarely held hostage to the highest tax rate (see Figure 3). The highest bracket tax filers have deductions, exemptions, exclusions, and all sorts of other methods available to them to pay far lower rates on average. Yet in spite of all these loopholes, the rich still paid a lot more taxes after Kennedy's tax cut, and they pay more now as well.

Today in our tax codes we have lots and lots of other impediments in addition to income taxes which affect the benefit-cost ratios for cutting tax rates in the various tax brackets. Compared to the Kennedy era, we have very different payroll taxes, state and local taxes, sales taxes, earned income tax credits, and so on and so forth. It is still true that for every dollar of static revenue change there is a much larger incentive effect in the highest tax bracket than in the lowest tax bracket. Again you can see why on a conceptual level we question the fiscal wisdom of cutting tax rates in the lower income categories while raising tax rates on higher income categories. The supply-side responses in the higher income categories should be far greater than the responses in the lower income categories. The result would be a huge decrease in tax revenues and huge increase in the budget deficit.

C. Access to Means to Shelter Income

In general, people who reside in the lowest income tax brackets have a lot less flexibility to change the form, timing, and location of their income to reduce their tax liability. Now this is not universally true as in the cases of artisans, part-time employees, etc. But in general, not only do low-income earners have less flexibility, but the avenues open to them to reduce their tax liabilities are far fewer than are the avenues open to higher income earners. Great examples of some of the avenues open are 401(k)s, IRAs, Keough plans, itemized deductions, lifetime gifts, charitable contributions, all sorts of deferred income compensation plans, trusts, tax-free bonds, etc. And as a final point, the culture surrounding low income earners is not nearly as focused on tax avoidance as it is in higher income earners, therefore fewer lower income earners even avail themselves of the limited programs, laws and other opportunities to reduce their tax liabilities. What this means is that the supply of taxable income in the highest tax brackets is far more elastic than it is in the lower tax brackets, all other things being equal. Again, this observation leads us to question the fiscal assumptions underlying the Democrats plan to raise taxes on the rich and lower taxes on the middle and lower income earners. Tax increases in the highest tax bracket will have a far greater negative response for taxable income than tax cuts will have positive responses in lower tax brackets.

D. Tax Avoidance is More Profitable the Higher the Income

Many of the tax avoidance methods available to income earners require expert advice and counsel from people such as tax accountants, lawyers, deferred compensation experts, and yes, even economists. These services are expensive and are progressively out of the reach of lower income earners. People who earn more find tax accountants and lawyers and other financial professionals far more cost effective than do people with lesser incomes, not only because the costs are spread over larger sums, which they are, but because the pursuit of tax avoidance is dollar for dollar more profitable with higher tax rates. Tax avoidance schemes make no sense when tax rates are zero. The higher tax rates are the more benefit income earners receive from tax avoidance plans. This again materially alters the supply elasticity of reported taxable income by earners according to their tax brackets, making the taxable incomes of those who earn more, more elastic, and the taxable incomes of those who earn less, less elastic. Tax cuts in the lowest tax brackets and tax increases in the highest tax

brackets tilt the economy toward revenue losses. It's sad but true. But truth is what the Democrats need in order to avoid the potentially disastrous consequences that would result if their proposed tax plans were actually put into effect.

II. A Conceptual Framework to View the Data and Tax Rates

This section focuses on how to evaluate the empirical relationship between the maximum tax rate on personal income, corporate income, capital gains, dividends or inheritance, and tax receipts realized from those categories. The relationship between tax rates and revenues is fascinating and important, but is not the end all and be all with respect to the issue of whether to tax these categories and, if so, at what rates. Nonetheless, the following points reflect the conceptual structure of just how one should go about evaluating the fiscal responses to tax rate changes.

- It is hard for us to understand why anyone would ever wish to tax, say, capital gains at tax rates that exceed those tax rates where revenues are maximized. It seems to us that if lowering capital gains tax rates would actually increase capital gains tax revenues, then we should lower those tax rates at least until capital gains tax revenues stopped rising. Everyone would be better off—both taxpayers, who would pay less, and those who receive benefits from the government, who would receive more.
- But even if a capital gains tax rate cut did not yield more direct capital gains tax revenues, there may still be compelling unambiguous reasons to cut the capital gains tax rate. A capital gains tax rate cut will increase investments, employment, profits, sales, etc., in addition to yielding more realized capital gains. Each of these separately, and all of these together, will increase tax receipts from other sources such as income taxes, payroll taxes, sales taxes, etc. From the standpoint of U.S. government tax revenues, it is appropriate to look at the total increase (or decrease) in U.S. tax receipts from a capital gains tax rate cut, not just those receipts from the capital gains tax alone. Here again, it's a no brainer to cut the capital gains tax rate if total federal tax receipts rose as a result of a capital gains tax rate reduction. Again, everyone would be better off—taxpayers and government spending beneficiaries.
- But even if a capital gains tax rate cut did not yield more federal tax receipts, let alone more capital gains tax receipts, there may still be compelling unambiguous reasons that everyone would agree with to cut the capital gains tax rate. A capital gains tax rate cut will expand output, employment, and productivity, which in turn will reduce federal expenditures—especially those expenditures predicated upon needs tests, means tests and incomes tests. These categories of spending include unemployment benefits, food stamps, supplemental security income, housing subsidies, as well as many other programs. Quite simply, a capital gains tax rate cut will reduce the number of people in need and therefore federal expenditures. Lower expenditures, if sufficiently large to offset a shortfall in total federal tax revenues, will still make a capital gains tax rate cut an unambiguous win/win situation. As long as a capital gains tax rate cut results in less government debt then no one can oppose the tax rate cut. There are no fiscal arguments against cutting capital gains tax rates under these circumstances.
- But going even further, if federal tax receipts fall by more than federal expenditures decline thus resulting in more federal debt, there is also a serious consideration to be paid to state and local fiscal conditions. If the increase in the federal debt were to be offset by a decline in state and local debt, then it is still very hard for us to see why a cut in the federal capital gains tax rate wouldn't be warranted for virtually all constituencies. Why such a tax rate cut would be controversial is beyond us. To us, if total government debt resulting from a capital gains tax rate cut were not to increase, there are really no arguments against cutting the capital gains tax rate.
- But even the above points aren't enough to contain the issue. When considering whether or not a cut in the capital gains tax rate increases or lowers total government debt, there needs to be an effective time frame. In general, the longer the time frame, the more likely it will be that revenue feedback effects and spending reduction effects will materialize. Conceptually, what would be ideal is to take the discounted present value of all the net debt effects resulting from a cut in the capital gains tax rate, and if that present value calculation reveals a reduction in net debt, the answer would be to cut the federal capital gains tax rate under any and all circumstances. This truly is what the prohibitive range of the Laffer Curve is all about.

But the Laffer Curve is not—and we repeat not—the whole consideration for deciding whether or not to tax capital gains and, if so, at what rate. Revenue, expenditure and debt feedbacks are only three considerations, albeit big ones. The role of government is to improve the lot of all Americans. The special role of taxes is to provide government with the requisite revenues to achieve its objectives. All taxes—save sin taxes—are bad because they have the effect of reducing the taxed activity. Therefore, the role of the state should be to collect the requisite revenues while doing the least damage. Any tax rate at or above that tax's maximum revenue point hurts total economic activity with no revenue offset. How dumb is that? Tax rates should be significantly below the maximum revenue tax. The purpose of government is to make people better off, not to maximize revenues.

III. The U.S. Income Tax Return Data—Taxing the Rich

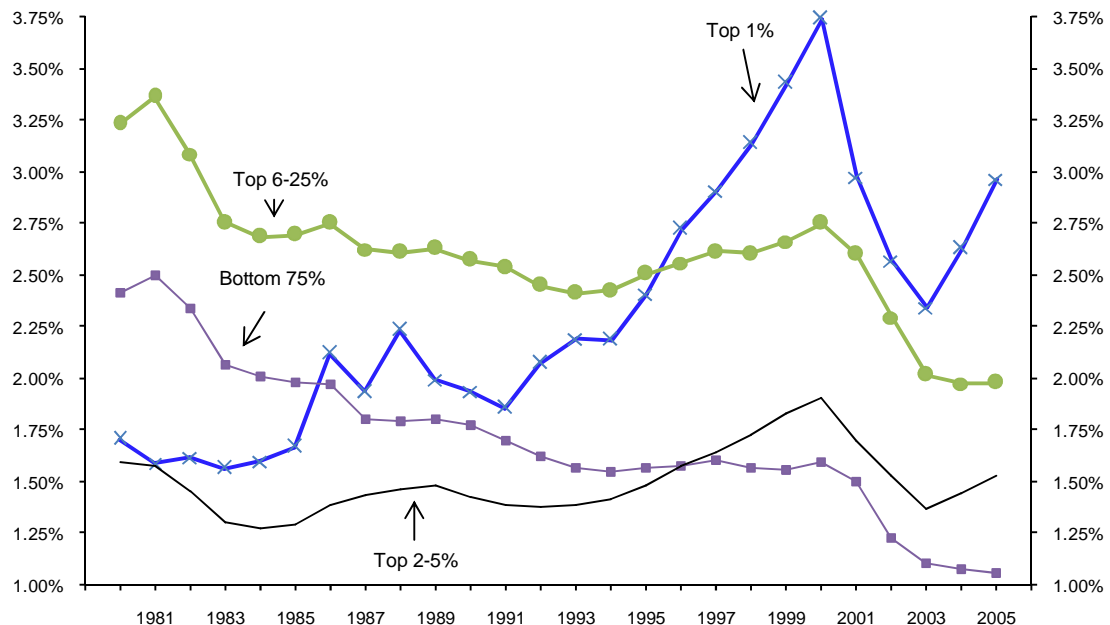
Over the past quarter century, we have witnessed enormous shifts in the composition and volume of income tax payments by the highest income earners. In the year Ronald Reagan took office (1981) the top 1% of income earners as reflected by the Adjusted Gross Income of all tax filers paid 17.58% of all federal income taxes.⁵ Twenty-five years later, in 2005 the top 1% paid 39.38% of all income taxes, representing a greater than doubling of the share of tax payments made by this group.

But even more to the point, from 1981 to 2005 the income taxes paid by the top 1% rose from 1.59% of GDP to 2.96% of GDP (see Figure 2). In addition to the huge rise in the percent of GDP paid in income taxes by the top 1% of income earners and the more than doubling of the share of taxes paid by this group was the huge absolute increase in real taxes (2005 dollars using the GDP price deflator) from 1981 through 2005. In 1981, total tax payments from the richest 1% were \$94.84 billion, while in 2005 the top 1% paid \$368.13 billion in income taxes; that's a 288% increase in 25 years. In rough numbers, that means that each of the richest 1% of filers in 1981 paid a little over \$100,000 in 2005 dollars, while in 2005 each filer on average paid over \$288,000. And remember that's inflation-adjusted dollars.

In 2000 this teeny, tiny group of only 1% of all taxpayers actually paid income taxes equal to 3.75% of GDP, which is why President Clinton had a budget surplus. Much of this huge surge in tax payments by the top 1% of tax filers resulted from the huge increase in capital gains resulting from President Clinton reducing the federal capital gains tax rate from 28% to 20% in 1997 (see Figure 1). He also effectively eliminated the capital gains tax on owner-occupied homes. But more on this later.

Let's take a look at the bottom 75% of taxpayers over this same time period. This has to be the group which the current Democrats refer to as middle and lower income earners. From 1981 through 2005, the bottom 75% of all income earners as reported on the individual income tax returns went from 27.71% of all income taxes paid to 14.01% in 2005. Yes that's 75% of all taxpayers save the top 25%. As a share of GDP, total taxes paid by the bottom 75% of all taxpayers fell from 2.50% of GDP in 1981 to 1.05% of GDP in 2005. The bottom 75% of all taxpayers today pay less than 35% of all the taxes paid by the top 1% of all income earners. This is the very group the Democrats are targeting for tax cuts. Over the last 25 years, the bottom 75% of all taxpayers' tax payments fell and their tax rates fell. Guess what will happen if they lower these tax rates further?

Figure 2
Income Taxes Paid as a Percentage of GDP: Top 1%, Top 2-5%, Top 6-25%, Bottom 75%



Source: Tax Foundation Tables 1 – 7, IRS, Statistics of Income, Table 5, F.R.E.D

⁵ Tax Foundation Tables 1 – 7, IRS, Statistics of Income

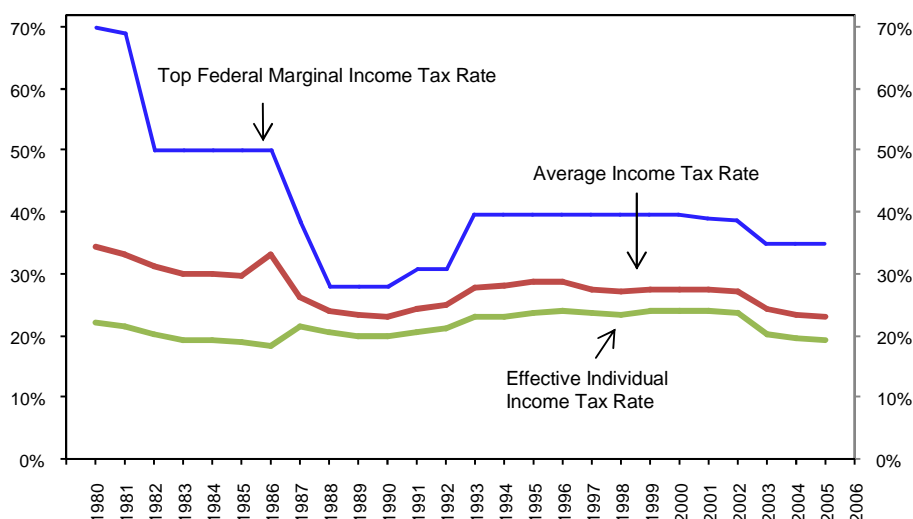
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The important point here is that over the last 25-plus years the only group who experienced an increase in income taxes paid as a share of GDP was the top 1% of income earners. Even the top 2-5% of income earners saw a decline in the GDP share of their income taxes paid. It is amazing. But this is only the beginning of the story.

The second part of this story is a juicy part. Since 1980, statutory marginal personal income tax rates have fallen dramatically. The highest marginal income tax rate has fallen from 70% in 1980 to 35% today, with a low of 28% resulting from the 1986 tax reform act. This 28% highest tax rate lasted until Presidents Bush Sr. and Clinton raised that rate in 1991 and then again in 1993. In Figure 3 below we have plotted the highest federal marginal income tax rate from 1980 through 2005.

To show the actual tax impact from cutting marginal income tax rates, we have also plotted the average income tax rate for the top 1% of income earners, which consists of total taxes paid by the top 1% of income earners divided by their total Adjusted Gross Income as reported on their income tax returns. There is a significant drop in this average tax rate from 1979 until about 1987 and then the average tax rate of the richest 1% of taxpayers levels off, rising slightly in the 1991-1993 period and falling back again in the 2001-2005 period.

Figure 3
Top Marginal, Average, and Effective Individual Income Tax Rates for the Top 1%, 1980-2005



Source: Tax Foundation Table 1-7. IRS Statistics of Income Table 5, Table A. CBO "Historical Effective Tax Rates 1979-2005" Table 1A

While it would be tempting to attribute the sharp fall in the average tax rate of that top 1% of taxpayers to the enormous drop in the highest marginal statutory tax rate, in truth much of the answer is really a lot simpler: the definition of adjusted gross income changed over this period. To quote from the Treasury Department:

The most significant revisions came in the Tax Reform Act of 1986 (TRA86). Among these were the full inclusion of long-term capital gains (previously, 40% was included in the AGI, and before 1979, 50% had been included). TRA86 also imposed limits on "passive losses" that would be allowed in calculating AGI. It changed moving expenses and unreimbursed employee business expenses from income "adjustments" to itemized deductions. (Starting in 1994, moving expenses were again allowed as an adjustment to income instead of as an itemized deduction.) It eliminated the adjustment to income for a married couple with a second earner and the exemption for the first \$400 of dividends received. Working to narrow the definition of AGI, it allowed self-employed individuals a deduction for up to 25 percent of their health insurance premiums.⁶

But now we get to the secret sauce and the essence of what really happens in the realm of tax rates, incomes and tax payments by the rich. The Congressional Budget Office calculates "effective individual income tax rates" by dividing the total tax payments by the comprehensive household incomes of the top 1% of tax filers. Because this concept is so important and is also so correct, we quote directly from the CBO herein:

Comprehensive household income equals pretax cash income plus income from other sources. Pretax cash income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends,

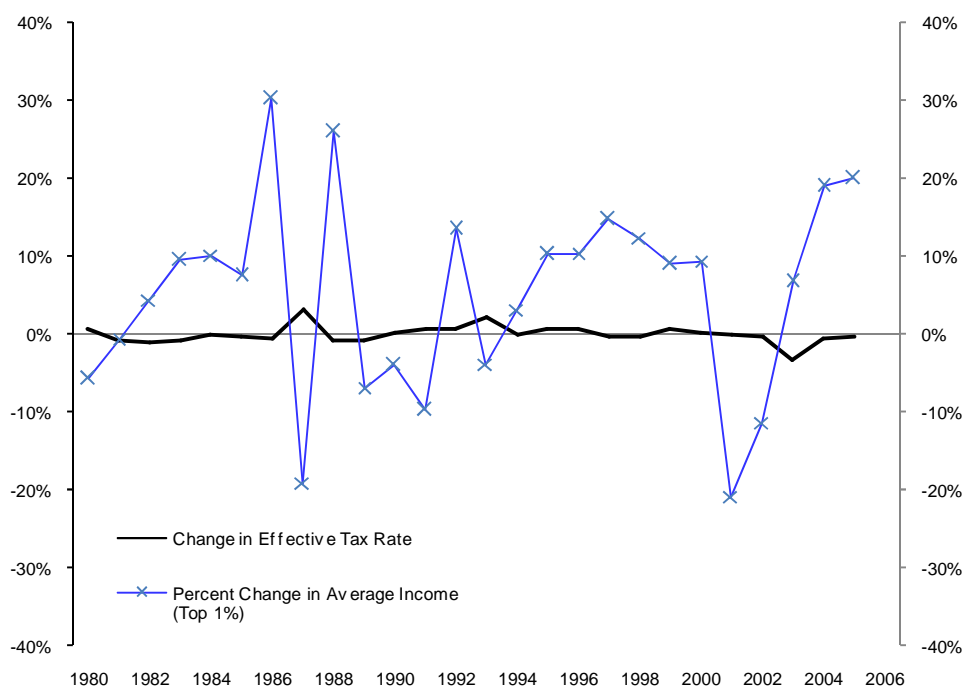
⁶ Susan C. Nelson, "Adjusted Gross Income," Department of the Treasury, <http://www.urban.org/UploadedPDF/1000514.pdf>.

realized capital gains, cash transfer payments, and retirement benefits plus taxes paid by businesses (corporate income taxes and the employer's share of Social Security, Medicare, and federal unemployment insurance payroll taxes) and employee contributions to 401(k) retirement plans. Other sources of income include all in-kind benefits (Medicare, Medicaid, employer-paid health insurance premiums, food stamps, school lunches and breakfasts, housing assistance and energy assistance).⁷

Now we have accurate data on both total taxes paid by the top 1% of income earners and their comprehensive household income. From these two data series we can calculate the effective individual income tax rate for the top 1% of all income earners (see Figure 3).

Surprise, surprise, the effective individual income tax rate for the top 1% of income earners barely wiggles as Congress changes tax codes after tax codes and the economy goes from boom to bust and back again. The question is how can that effective individual income tax rate be so stable? The answer is simply that the very highest income earners are and have always been able to vary their reported income and thus control the amount of taxes they pay. Whether through tax shelters, deferrals, gifts, write-offs, cross income mobility or any of a number of other measures, the effective individual income tax rate barely budes. But this group's total tax payments are incredibly volatile.

Figure 4
Change in Comprehensive Household Income vs. Change in the Effective Individual Income Tax Rate for the Top 1% of Income Earners



Source: Congressional Budget Office

The only conclusion one can come to is that by raising statutory tax rates on the rich as proposed by the Democrats, the effective individual income tax rate won't change, but the comprehensive household income earned by this group will fall, thus resulting in a sharp decline in tax receipts from the very highest income earners. If you want to get more tax revenues from the rich, you've got to make the rich richer, and to make the rich richer, you've got to lower tax rates.

Now let's take a look at the bottom 75% of income earners.

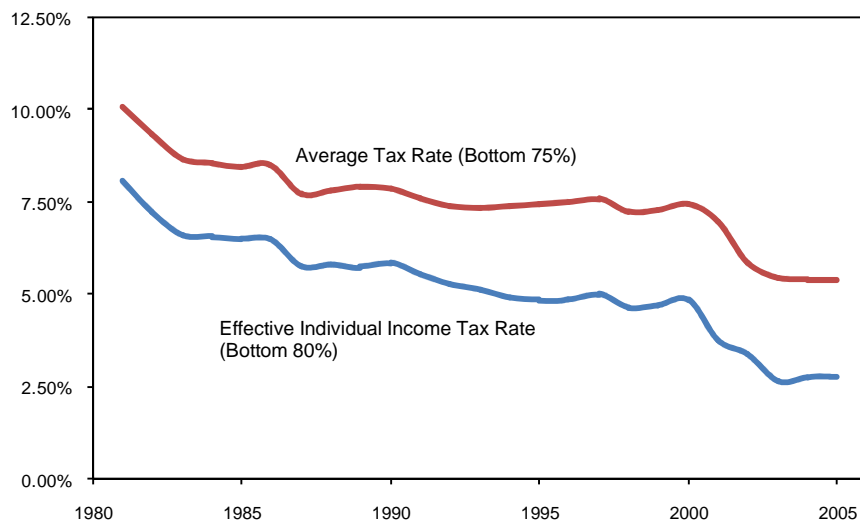
Using the same measures as we did for the top 1% of income earners, we quickly learn that the rich are not at all like the rest of us. As we saw in Figure 2, the share of total taxes paid by the bottom 75% of income earners fell from 2.5% of GDP in 1981 to slightly over 1% of GDP in 2005.

⁷ "Historical Effective Federal Tax Rates: 1979 to 2005," Congressional Budget Office, <http://www.cbo.gov/ftpdoc.cfm?index=8885&TYPE=2>

As a share of total tax payments, the bottom 75% went from 27.71% of all income taxes paid in 1981 to 14.01% in 2005. But if you look at legislated statutory tax rates on the middle and lower income earners, they too have been reduced quite dramatically over the past quarter century.

In Figure 5, we use both the bottom 75% and the bottom 80% as our measure of the middle and lower class income earners. The reason for this switch is that the Congressional Budget Office uses quintiles whereas the Statistics of Income of the IRS uses quartiles. In this table we plot the effective individual income tax rate for the bottom 80% all income earners. This number represents all taxes paid by the bottom 80% of income earners divided by their comprehensive household income as described by the Congressional Budget Office. As is apparent from these data, the effective individual income tax rate of the bottom 80% of tax filers—that's the bottom 80%—has gone from 8.1% in 1981 to 2.8% in 2005. It's hard to get much money from these people when the effective tax rate is almost zero. As a result, the share of individual tax liabilities of this group is 13.7% of all income tax liabilities in 2005, down from 36.1% in 1981.

Figure 5
Average Tax Rate and Effective Individual Income Tax Rate of Middle and Lower Income Earners
(annual, through 2005)



Source: Tax Foundation Table 1-7. IRS Statistics of Income Table 5, Table A. CBO "Historical Effective Tax Rates 1979-2005" Table 1A

Putting it all together, there is no way from here to Sunday that lowering tax rates on middle and lower income earners will do anything other than lose revenues. Lowering these already low tax rates will lower revenues from the lower and middle income tax filers and will also lower tax revenues from the highest income earners.

Raising tax rates on the very highest income earners will also lower tax revenues. No amount of wishing or hoping will change this. Based on tax return data, the Democrats' tax plan will lead to a fiscal catastrophe.

IV. Tax Cuts and the Economy

Perhaps nothing better illustrates the importance of tax rates than the 30,000 foot view of the U.S. economy. What the Democrats are proposing is nothing short of a repudiation of the last 25 to 30 years of U.S. economic policy. To see the big picture here, we need to see what actually happened during the three great episodes of tax reduction in the U.S.: A) the Harding/Coolidge tax cuts, B) the Kennedy tax cuts and lastly C) the Reagan tax cuts.

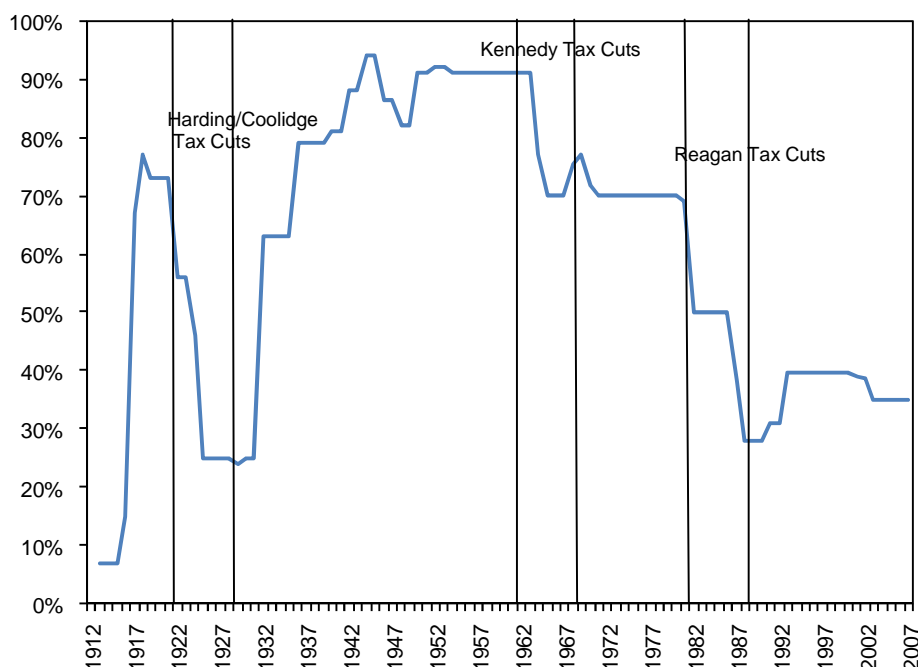
A. The Harding/Coolidge Tax Cuts

In 1913, the federal progressive income tax was put into place with a top marginal rate of 7% (see Figure 6). Thanks in part to World War I, this tax rate was quickly increased significantly and peaked at 77% in 1918. Then, through a series of tax-rate reductions, the Harding/Coolidge tax cuts dropped the top personal marginal income tax rate to 25% in 1925.

While tax collection data for the National Income and Product Accounts (from the U.S. Bureau of Economic Analysis) don't exist for the 1920s, we do have total federal receipts from the U.S. budget tables. During the four years prior to 1925 (the year the tax cut was fully enacted), inflation-adjusted revenues declined by an average of 9.2% per year (see Table 3). Over

the four years following the tax-rate cuts, revenues remained volatile but averaged an inflation-adjusted gain of 0.1% per year. The economy responded strongly to the tax cuts, with output nearly doubling and unemployment falling sharply.

Figure 6
The Top Marginal Personal Income Tax Rate, 1913-2007
(when applicable, top rate on earned and/or unearned income)



In the 1920s, tax rates on the highest income brackets were reduced the most, which is exactly what economic theory suggests should be done to spur the economy.

But those income classes with lower tax rates were not left out in the cold: The Harding/Coolidge tax-rate cuts did result in reduced tax rates on lower income brackets. Internal Revenue Service data show that the dramatic tax cuts of the 1920s resulted in an increase in the share of total income taxes paid by those making more than \$100,000 per year from 29.9% in 1920 to 62.2% in 1929 (Table 2). And keep in mind the significance of this increase, given that the 1920s was a decade of falling prices and therefore a \$100,000 threshold in 1929 corresponds to a higher real income threshold than \$100,000 did in 1920. The consumer price index *fell* a combined 14.5% from 1920 to 1929. In this case, the effects of bracket creep that existed prior to the federal income tax brackets being indexed for inflation (in 1985) worked in the opposite direction.

Perhaps most illustrative of the power of the Harding/Coolidge tax cuts was the increase in GDP, the fall in unemployment and the improvement in the average American's quality of life over this decade.

Table 2
Percentage Share of Total Income Taxes Paid
By Income Class: 1920, 1925 and 1929

Income Class	1920	1925	1929
Under \$5,000	15.4%	1.9%	0.4%
\$5,000-\$10,000	9.1%	2.6%	0.9%
\$10,000-\$25,000	16.0%	10.1%	5.2%
\$25,000-\$100,000	29.6%	36.6%	27.4%
Over \$100,000	29.9%	48.8%	62.2%

Source: Internal Revenue Service

Table 3
A Look at the Harding/Coolidge Tax Cut

Before and After: Federal Government Receipts					
(in \$billions, fiscal year U.S. budget data)					
		Federal Government			
	Fiscal Year	Revenue	yr/yr % change	Inflation-Adjusted Revenue	yr/yr % change
4-Year Average Before Tax Cut	FY1920	\$6.6		\$6.6	
	FY1921	\$5.6	-16.2%	\$6.2	-6.1%
	FY1922	\$4.0	-27.7%	\$4.8	-23.0%
	FY1923	\$3.9	-4.3%	\$4.5	-6.0%
	FY1924	\$3.9	0.5%	\$4.5	0.0%
			-12.6%		-9.2%
4-Year Average After Tax Cut	FY1925	\$3.6	-5.9%	\$4.2	-8.2%
	FY1926	\$3.8	4.2%	\$4.3	3.3%
	FY1927	\$4.0	5.7%	\$4.6	7.8%
	FY1928	\$3.9	-2.8%	\$4.5	-1.7%
			0.2%		0.1%

Before and After: Revenue, Output and Employment																				
annual average rate over four year period before and four year period after the tax cut																				
<div><div>Federal Real Revenue Growth</div><table><thead><tr><th>Period</th><th>Growth</th></tr></thead><tbody><tr><td>Before</td><td>-9.2%</td></tr><tr><td>After</td><td>0.1%</td></tr></tbody></table></div>	Period	Growth	Before	-9.2%	After	0.1%	<div><div>Real GDP Growth</div><table><thead><tr><th>Period</th><th>Growth</th></tr></thead><tbody><tr><td>Before</td><td>2.0%</td></tr><tr><td>After</td><td>3.4%</td></tr></tbody></table></div>	Period	Growth	Before	2.0%	After	3.4%	<div><div>Unemployment Rate</div><table><thead><tr><th>Period</th><th>Rate</th></tr></thead><tbody><tr><td>Before</td><td>6.5%</td></tr><tr><td>After</td><td>3.1%</td></tr></tbody></table></div>	Period	Rate	Before	6.5%	After	3.1%
Period	Growth																			
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B. The Kennedy Tax Cuts

During the Depression and World War II, the top marginal income tax rate rose steadily, peaking at an incredible 94% in 1944 and 1945 (see Figure 6). The rate remained above 90% well into President John F. Kennedy's term in office, which began in 1961. Kennedy's fiscal policy stance made it clear he was a believer in pro-growth, supply-side tax measures. Kennedy said it all in January of 1963 in the *Economic Report of the President*:

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.

Kennedy further reiterated his beliefs in his *Tax Message to Congress* on January 24, 1963:

In short, this tax program will increase our wealth far more than it increases our public debt. The actual burden of that debt—as measured in relation to our total output—will decline. To continue to increase our debt as a result of inadequate earnings is a sign of weakness. But to borrow prudently in order to invest in a tax revision that will greatly increase our earning power can be a source of strength.

President Kennedy proposed massive tax-rate reductions which passed Congress and went into law after he was assassinated. The 1964 tax cut reduced the top marginal personal income tax rate from 91% to 70% by 1965. The cut reduced lower-bracket rates as well. In the four years prior to the 1965 tax-rate cuts, federal government income tax revenue, adjusted for inflation, had increased at an average annual rate of 2.1%, while total government income tax revenue (federal plus state and local) had increased 2.6% per year (Table 4). In the four years following the tax cut these two measures of revenue growth rose to 8.6% and 9.0%, respectively. Government income tax revenue not only increased in the years following the tax cut, it increased at a much faster rate in spite of the tax cuts.

Table 4
A Look at the Kennedy Tax Cut

Before and After: Total Income Tax Revenue (Personal and Corporate)									
(in \$billions, calendary year BEA NIPA data)									
	Year	Federal Government				Total Government (Federal, State and Local)			
		Revenue	yr/yr % change	Inflation-Adjusted Revenue	yr/yr % change	Revenue	yr/yr % change	Inflation-Adjusted Revenue	yr/yr % change
4-Year Average Before Tax Cut	1960	\$63.2		\$63.2		\$67.0		\$67.0	
	1961	\$64.2	1.6%	\$63.5	0.5%	\$68.3	1.9%	\$67.6	0.9%
	1962	\$69.0	7.5%	\$67.5	6.2%	\$73.7	7.9%	\$72.1	6.6%
	1963	\$73.7	6.8%	\$71.2	5.5%	\$78.7	6.8%	\$76.0	5.5%
	1964	\$72.1	-2.2%	\$68.8	-3.4%	\$78.0	-0.9%	\$74.4	-2.1%
			3.3%		2.1%		3.9%		2.6%
4-Year Average After Tax Cut	1965	\$80.0	11.0%	\$75.1	9.2%	\$86.4	10.8%	\$81.1	9.0%
	1966	\$90.0	12.5%	\$82.0	9.2%	\$97.7	13.1%	\$89.1	9.8%
	1967	\$94.4	4.9%	\$83.7	2.1%	\$103.2	5.6%	\$91.5	2.8%
	1968	\$112.5	19.2%	\$95.7	14.3%	\$123.6	19.8%	\$105.1	14.9%
			11.8%		8.6%		12.2%		9.0%

Before and After: Revenue, Output and Employment									
annual average rate over four year period before and four year period after the tax cut									
Real Income Tax Revenue Growth			Real GDP Growth			Unemployment Rate			
Before	After		Before	After		Before	After		
2.1%	8.6%	Federal	4.6%	5.1%		5.8%	3.9%		
2.6%	9.0%	Total							

The Kennedy tax cut set the example that Reagan would follow some 17 years later. By increasing incentives to work, produce and invest, real GDP growth increased in the years following the tax cuts, more people worked and the tax base expanded. Additionally, the expenditure side of the budget benefited as well because the unemployment rate was significantly reduced.

Using the Congressional Budget Office's revenue forecasts made with the full knowledge of, yet prior to, the tax cuts, revenues came in much higher than had been anticipated, even after the "cost" of the tax cut had been taken into account (Table 5).

Table 5
Actual vs. Forecasted Federal Budget Receipts, 1964-1967
(in \$billions)

Fiscal Year	Actual Budget Receipts	Forecasted Budget Receipts	Difference	Percentage Actual Revenue Exceeded Forecasts
1964	\$112.7	\$109.3	+\$3.4	3.1%
1965	\$116.8	\$115.9	+\$0.9	0.7%
1966	\$130.9	\$119.8	+\$11.1	9.3%
1967	\$149.6	\$141.4	+\$8.2	5.8%

Source: Congressional Budget Office, *A Review of the Accuracy of Treasury Revenue Forecasts, 1963-1978* (February, 1981), p. 4.

In addition, in 1965, one year following the tax cut, personal income tax revenue data exceeded expectations by the greatest amounts in the highest income classes (Table 6).

Table 6
Actual vs. Forecasted Personal Income Tax Revenue by Income Class, 1965
(calendar year, revenue in \$millions)

Adjusted Gross Income Class	Actual Revenue Collected	Forecasted Revenue	Percentage Actual Revenue Exceeded Forecasts
\$0 - \$5,000	\$4,337	\$4,374	-0.8%
\$5,000 - \$10,000	\$15,434	\$13,213	16.8%
\$10,000 - \$15,000	\$10,711	\$6,845	56.5%
\$15,000 - \$20,000	\$4,188	\$2,474	69.3%
\$20,000 - \$50,000	\$7,440	\$5,104	45.8%
\$50,000 - \$100,000	\$3,654	\$2,311	58.1%
\$100,000+	\$3,764	\$2,086	80.4%
Total	\$49,530	\$36,407	36.0%

Source: Estimated revenues calculated from Joseph A. Pechman, "Evaluation of Recent Tax Legislation: Individual Income Tax Provisions of the Revenue Act of 1964," *Journal of Finance*, vol. 20 (May 1965), p. 268. Actual revenues are from Internal Revenue Service, *Statistics of Income -- 1965, Individual Income Tax Returns*, p. 8.

Testifying before Congress in 1977, Walter Heller, President Kennedy's Chairman of the Council of Economic Advisors, summed it all up:

What happened to the tax cut in 1965 is difficult to pin down, but insofar as we are able to isolate it, it did seem to have a tremendously stimulative effect, a multiplied effect on the economy. It was the major factor that led to our running a \$3 billion surplus by the middle of 1965 before escalation in Vietnam struck us. It was a \$12 billion tax cut, which would be about \$33 or \$34 billion in today's terms, and within one year the revenues into the Federal Treasury were already above what they had been before the tax cut.

Did the tax cut pay for itself in increased revenues? I think the evidence is very strong that it did.⁸

C. The Reagan Tax Cuts

In August of 1981, Ronald Reagan signed into law the Economic Recovery Tax Act (ERTA, also known as Kemp-Roth). ERTA slashed marginal earned income tax rates by 25% across-the-board over a three-year period (see Figure 6). The highest marginal tax rate on unearned income dropped to 50% from 70% immediately (the Broadhead Amendment) and the tax rate on capital gains also fell immediately from 28% to 20%. Five percentage points of the 25% cut went into effect on

⁸Walter Heller, in testimony before the Joint Economic Committee of Congress, 1977, quoted by Bruce Bartlett in the *National Review*, October 27, 1978.

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October 1, 1981. An additional 10 percentage points of the cut then went into effect on July 1, 1982, and the final 10 percentage points of the cut began on July 1, 1983.

Looking at the cumulative effects of ERTA in terms of tax (calendar) years, the tax cut provided a reduction in tax rates of 1.25% through the entirety of 1981, 10% through 1982, 20% through 1983, and the full 25% through 1984.

As a provision of ERTA, Reagan also saw to it that the tax brackets were indexed for inflation beginning in 1985.

To properly discern the effects of the tax-rate cuts on the economy, I use the starting date of January 1, 1983, given that the bulk of the cuts were in place on that date. However, a case could be made for a start date of January 1, 1984, the date the full cut was in effect.

These across-the-board marginal tax-rate cuts resulted in higher incentives to work, produce and invest, and the economy responded (see Table 8). Between 1978 and 1982 the economy grew at a 0.9% rate in real terms, but from 1983 to 1986 this growth rate increased to 4.8%.

Prior to the tax cut the economy was choking on high inflation, high interest rates and high unemployment. All three of these economic bellwethers dropped sharply after the tax cuts. The unemployment rate, which had peaked at 9.7% in 1982, began a steady decline, reaching 7.0% by 1986 and 5.3% when Reagan left office in January 1989.

Inflation-adjusted revenue growth dramatically improved. Over the four years prior to 1983, federal income tax revenue declined at an average rate of 2.8% per year, and total government income tax revenue declined at an annual rate of 2.6%. Between 1983 and 1986 these figures were a positive 2.7% and 3.5%, respectively.

The most controversial portion of Reagan's tax revolution was the big drop in the highest marginal income tax rate from 70% when he took office to 28% in 1988. However, Internal Revenue Service data reveal that tax collections from the wealthy, as measured by personal income taxes paid by top percentile earners, increased between 1980 and 1988 despite significantly lower tax rates (Table 7).

Table 7
Percentage of Total Personal Income Taxes Paid
by Percentile of Adjusted Gross Income (AGI)

Calendar Year	Top 1% of AGI	Top 5% of AGI	Top 10% of AGI	Top 25% of AGI	Top 50% of AGI
1980	19.1%	36.8%	49.3%	73.0%	93.0%
1981	17.6%	35.1%	48.0%	72.3%	92.6%
1982	19.0%	36.1%	48.6%	72.5%	92.7%
1983	20.3%	37.3%	49.7%	73.1%	92.8%
1984	21.1%	38.0%	50.6%	73.5%	92.7%
1985	21.8%	38.8%	51.5%	74.1%	92.8%
1986	25.0%	41.8%	54.0%	75.6%	93.4%
1987	24.6%	43.1%	55.5%	76.8%	93.9%
1988	27.5%	45.5%	57.2%	77.8%	94.3%

Source: Internal Revenue Service

Conclusion

All in all, after economic theory and a review of the three great eras of major supply-side tax cuts, the evidence once again points out the fallacy of the Democrats' proposal to raise tax rates on the rich while lowering tax rates on middle and lower income earners. Ignoring the evidence could well lead America into a fiscal crisis that will last for years and years.

Trained economists know all of this is true, but they try to rebut the facts nonetheless because they believe it will curry favors with their political benefactors. Our country will be the real loser.

Table 8
A Look at the Reagan Tax Cut

Before and After: Total Income Tax Revenue (Personal and Corporate)									
(in \$billions, calendar year BEA NIPA data)									
	Year	Federal Government				Total Government (Federal, State and Local)			
		Revenue	yr/yr % change	Inflation-Adjusted Revenue	yr/yr % change	Revenue	yr/yr % change	Inflation-Adjusted Revenue	yr/yr % change
4-Year Average Before Tax Cut	1978	\$260.3		\$260.3		\$307.4		\$307.4	
	1979	\$299.0	14.9%	\$268.7	3.2%	\$350.8	14.1%	\$315.3	2.6%
	1980	\$320.3	7.1%	\$253.5	-5.7%	\$377.4	7.6%	\$298.7	-5.3%
	1981	\$356.3	11.2%	\$255.6	0.8%	\$419.6	11.2%	\$301.0	0.8%
	1982	\$344.0	-3.5%	\$232.5	-9.0%	\$410.0	-2.3%	\$277.1	-7.9%
			7.2%		-2.8%		7.5%		-2.6%
4-Year Average After Tax Cut	1983	\$347.5	1.0%	\$227.6	-2.1%	\$421.7	2.9%	\$276.2	-0.3%
	1984	\$376.6	8.4%	\$236.5	3.9%	\$462.9	9.8%	\$290.7	5.2%
	1985	\$412.3	9.5%	\$250.0	5.7%	\$504.6	9.0%	\$306.0	5.3%
	1986	\$433.9	5.2%	\$258.2	3.3%	\$534.0	5.8%	\$317.8	3.9%
			6.0%		2.7%		6.8%		3.5%

Before and After: Revenue, Output and Employment									
annual average rate over four year period before and four year period after the tax cut									

Real Income Tax Revenue Growth

Category	Before	After
Federal	-2.8%	2.7%
Total	-2.6%	3.5%

Real GDP Growth

Period	Growth
Before	0.9%
After	4.8%

Unemployment Rate

Period	Rate
Before	7.6%
After	7.8%

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