SEMANTICS OF THE FLAT RATE TAX AND TAX REFORM

Joseph J. Minarik

Two of the most frequently used terms in economics and politics today are "flat rate tax" and "tax reform." Hardly a policy agenda appears that does not include one or both. Yet these terms mean different things to different people. The current imprecision may cause some confusion, and may delay and distract the political debate. An evaluation of the role of these concepts today might not get far beyond a definition of terms. This analysis will try to get at least that far, with a few subjective observations along the way.

What Is the Flat Rate Tax?

For a policy option whose hallmark is simplicity, the flat rate tax has become a surprisingly complex and slippery concept. The federal income tax has had graduated rates since its inception. Until World War II, the upper graduated rates affected only a few people—but so did the lowest rate, for that matter, because only a small minority of the population paid income tax at all. The rates themselves were quite low, except in the period during and immediately after World War I.

World War II brought the income tax to a majority of the population and pushed the highest marginal rates above 90 percent for the first time. The postwar buildup in strategic arms and the Korean conflict kept government spending high and required continuation of high tax rates. It was in the subsequent atmosphere of somewhat reduced tensions that the high and steeply graduated marginal tax rates, previously accepted in the spirit of wartime sacrifice, were first questioned.

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Pure and Practical Flat Taxes

To many, the connotation of a "flat tax" is something that is completely uncompromised; all income is subject to tax and is taxed at a single rate. That was not the form that the most prominent early flat tax proposal took. When Blum and Kalven (1953) raised their objections to "the uneasy case for progressive taxation," they proposed in its place what they called a "degressive tax," that is, a tax at a single rate on all income above some exemption or standard deduction. The exemption or deduction was included to avoid the ethical failing of imposing taxes on the poor (though there was no official definition of poverty at the time).

With the low-income relief of their degressive tax, Blum and Kalven introduced a certain arbitrariness into the flat tax concept. They admit that the appropriate size for the exemption or deduction is necessarily controversial. It is but a short step from the degressive tax to any number of variations that bear little resemblance to the traditional notion of a pure flat tax.

Modified Flat Taxes

In fact, the current tax debate has moved from the flatness of the billiard table to the finely drawn distinctions of a quality relief map. The issue is not flatness in absolute terms, but rather comparative degrees of flatness. Milton Friedman, a long-standing advocate of the flat tax, has himself argued for imposing a maximum marginal rate (usually 25 percent) at the top of the current graduated tax schedule (Friedman 1980). This would put a sizable minority of taxpayers into a single marginal rate bracket, but it would leave little of total income subject to tax in that bracket. Thus, it would be a flat tax at the margin for the few, but by no means a flat tax for the many.

After Friedman's suggestion, numerous analysts have tried other variations on the basic flat tax theme to achieve particular combinations of objectives. Of the prominent tax proposals currently on the table, only one—the Hall-Rabushka package introduced by Senators Dennis DeConcini and Steven Symms—could be described as a flat rate tax by even the very general definition of having a single tax rate. And even that proposal seems somewhat distant from the mainstream of policymakers' thinking at this time.

The object of most policymakers' affection now is the so-called modified flat tax (this term being an improvement of the prototype "progressive flat tax"). The modification, of course, is that the modified flat tax is not flat. Two of the proposals in this category, the Treasury's package of November 1984 and the "Fair Tax" proposed by Senator Bill Bradley and Representative Richard Gephardt, employ only three tax rate brackets (down from the current law's 14 non-zero rate brackets for married couples and 15 for single people), with the lowest bracket extending high enough on the income scale to accommodate upward of 70 percent of all taxpayers (Friedman's suggestion stood on its head). These proposals are flat taxes, therefore, for the majority of the population; but they both specify significant progressivity at the upper end of the income scale (with maximum rates of 35 percent and 30 percent, respectively). A third prominent proposal, the Kemp-Kasten "FAST Tax," has a basic tax rate of 24 percent, but allows a 20 percent exclusion of earned income up to the amount of the social security payroll tax wage base, phasing the exclusion out over the next roughly $60,000 of earned income. Thus, the Kemp-Kasten bill has what is in effect another three-bracket system, but in this case with the highest rate in the middle (where the earned income exclusion phases out).

The reason for the algebraic gymnastics in the Kemp-Kasten proposal, and the reason why the Hall-Rabushka proposal has not caught on outside of a relatively narrow circle, is simply that a single marginal rate of tax, whatever the low-income allowances, will significantly redistribute the tax burden. In particular, with low-income relief provisions anywhere near the levels of the current law, the single-rate tax will lift a sizable share of the tax burden from upper income groups and increase the tax burden for median income groups. Members of Congress and others have been reluctant to endorse approaches that would increase the tax liabilities of the majority of their constituents.

The only defense against these redistributive effects within the constraint of a single tax rate is to cut the yield of the tax (either by reducing the tax rate or increasing the low-income relief) until middle income taxpayers are held harmless. This leaves the federal government short of revenue, of course; it also gives upper income taxpayers even larger tax cuts.

Both the revenue loss and the upper income tax cuts have been denied by some advocates on the ground that there would be substantial supply-side increases in income and tax revenues on the part of these upper income taxpayers. Regardless of whether these supply-side effects would materialize, several factors must be kept in mind. First, the federal budget is now in substantial deficit. If a flat rate tax with a substantial revenue cost is enacted, and if the supply-side responses do not materialize, the short-term economic costs could be catastrophic, and the long-term costs would certainly be serious. Second, unlike the 1981 across-the-board tax rate cuts, a flat rate tax would reduce the marginal tax rate and thus enhance incentives almost exclusively for the upper income population; thus, the flat rate tax's supply-side leverage on the population as a whole would be less. Although the claims of supply-side responses to the 1981 law focus mainly on these upper income groups, it is clear that the responses, if they have occurred, have not yielded sufficient revenues to control the deficit.

In sum, there are no pure flat rate tax proposals (meaning a single tax rate and no relief to lower income groups) on the market today. This should not be surprising, nor should it be lamented; the tradition of the last 20 years of lifting the tax burden from the poor should be continued. The flat tax mantle, however, can easily be spread over such tax systems as the Hall-Rabushka proposal, but these systems have failed to hold center stage.

Should the modified flat tax, in its many incarnations, be considered part of this flat tax family? The 1984 Treasury proposal and the Bradley-Gephardt proposal are single-rate taxes for the bulk of the population. On the other hand, there are precedents from traditional tax reform for lower rate income taxes with many fewer brackets (for example, the Treasury's 1977 Blueprints for Basic Tax Reform had three income tax brackets). Thus, the parentage of the modified flat tax is uncertain, though there are apparent family resemblances from both the flat tax and the tax reform clans. If the lineage of the modified flat tax is subject to dispute, how do the two strains embodied in it relate to one another?

What Is Tax Reform?

As noted earlier, there has been an identifiable strain of tax policy analysis known as "tax reform" for some time. But in recent years, this strain has become even more confused than the flat tax concept. This confusion is due mainly to the differing values of various analysts and policymakers. In part, however, the confusion about the identity of tax reform is due to the political appeal of the term. According to one of the tongue-in-cheek "Ten Commandments of Tax Policy," "Whatever you want to do, call it reform." This section examines the subcategories of tax reform to see how the flat tax fits in. What is tax reform, and how does it relate to our recent policy debate?

Economic Income

Perhaps the most traditional strain of the tax reform school calls for the use of an economic measure of income. This strain points out the distinctions between the "true" income of taxpayers, including all accretions to their economic well-being, and the measure of income that is used for tax purposes. The earliest contributions to this school of thought were absolutely fundamental to the development of scholarly thinking on income taxation (Haig 1921; Simons 1938). It was this scholarly literature that led to the understanding of income for tax purposes as consumption plus the increase of net worth over a given accounting period.

Departures from the true measure of income are seen as harmful by this school of tax reform for at least four reasons. First, if some income is categorically excluded from taxation, recipients of that income are unfairly advantaged. Second, those who do not in the first instance receive their income in the preferred forms will be induced to move into the preferred forms of economic activity, thereby distorting the allocation of resources and reducing national income. Third, some taxpayers will try to take advantage of the tax preferences in an artificial way through legal and accounting devices, thereby complicating tax administration and eroding the integrity of the tax system. And finally, tax preferences result in lost revenue, thereby forcing tax rates up, dampening incentives for productive economic activity, and increasing incentives for tax avoidance and evasion.

The recent activity of this school of tax reform has been the measurement of the margin between economic income and income as defined for tax purposes (Pechman 1965; Pechman and Okner 1972; Minarik 1980). These measurements serve to identify the sources of divergence between economic income and income for tax purposes and to show the relative importance of these various sources. A natural outgrowth of these measurements is the ability to predict the growth of the tax base that would result if particular departures from an economic measure of income were eliminated. These results can be used to determine the tax rate reductions that could be allowed if the tax base were broadened in particular ways. The end products are schemes for tax reform in this traditional mold, typically involving substantially reduced marginal tax rates at a constant level and distribution of the tax burden (Pechman and Okner 1972; Minarik 1977). From the traditional tax reform point of view, the reduction in marginal rates is vital; the increase in incentives for productive activity and the decrease of incentives for avoidance and evasion rate almost as high in importance as the greater neutrality of the elimination of tax preferences.

Tax reform defined in this way clearly resembles the flat tax in its purest form. Similarly, with its emphasis on lower marginal tax rates, traditional income tax reform has much in common with the flat tax. Some conflict arises, however, over maintaining the distribution of the tax burden. The single-rate tax necessarily redistributes the tax burden from the most well-to-do to the middle class. This result is not determined theoretically, but rather empirically, from the degree to which elimination of existing income tax preferences increases the size of the tax base at different levels up and down the income scale.

Measuring Income during Inflation

The United States has endured substantial inflation since the genesis of the recent interest in the flat tax and tax reform. Economic research has increasingly emphasized the adverse effect of inflation on the measurement of income from capital. It is well known that inflation erodes the principal amount of fixed-income assets, leaving some of the interest receipts, in effect, to keep the principal value whole. Because all of the interest is taxed, however, taxable income exceeds real income; in fact, depending on the circumstances, the tax due can exceed the real income. Likewise, real capital gains are overstated when measured by nominal gains, because inflation erodes the purchasing power of the originally invested principal. Finally, depreciation deductions based on historical cost fall short of the replacement cost of physical capital assets when there is inflation.

There seems little doubt that inflation neutrality would be desirable in principle. The issue is how to attain it. Within the confines of the income tax, indexing the basis of capital assets is the only way. Owners of fixed-income assets would need to claim negative income each year, equal to the inflation-induced depreciation of the principal amount of their assets. Taxpayers who realize capital gains would claim an adjustment to the basis of their assets. Depreciation deductions would be adjusted for the increase of replacement cost due to inflation.

An alternative route is using an expenditure rather than an income base for the entire tax. Under the expenditure tax all purchases of capital assets would be immediately deductible as saving (as opposed to consumption, which is the base of the tax). Transition to an expenditure tax would be a complicated matter, however, with particular problems in dealing with the consumption of retirees out of prior fully taxed savings.

Some analysts have concluded that tax reform must include an indexation of the income base for inflation. That principle underlies the Treasury I proposal (1984). Other analyses stress the difficulty and complexity of indexing the tax code without leaving distortions greater than those caused by inflation. Moreover, any judgment on indexation involves an implicit forecast of future inflation. If prices are relatively stable, the costs of indexation may well exceed the costs of inflation in an unindexed system; with more rapid inflation, this comparison is certainly reversed (Aaron 1976).

The flat tax may or may not harmonize with indexation. Again, in principle, taxing real income is probably preferable, even though in practice indexation is extraordinarily complex, and may well clash with the simplification aspect of the flat tax. The Treasury plan confirms this problem. Rather than indexing interest income precisely, asset by asset, Treasury I opted for a simpler but imprecise rule-of-thumb approach. The complexity of true indexation was judged simply too great for the average taxpayer to handle. Complexity is a real issue for the average taxpayer, because over half of all tax returns report some interest income.

A further issue in indexation is interest expense. Just as inflation causes interest income to be overstated, it also causes interest expense to be overstated. Indexing interest expense is essential if interest income is indexed; otherwise, taxpayers can design combined borrowing-and-lending transactions wherein they pay tax on only real interest income while they deduct nominal interest expense, enriching themselves at the expense of the Treasury with no economic benefit to society. Indexing interest expense is not only complex; it is also painful. Borrowers, particularly those who borrowed at high, inflation-influenced interest rates, would be indignant at additions to their taxable income because of inflation's erosion of the real value of their debts. To avoid this political firestorm, Treasury I exempted all mortgage debt from indexation, thereby leaving a huge preference, perhaps even greater than the preference in the current law, for owner-occupied housing.

Whether a flat tax should be indexed is thus a multifaceted decision. Purists for taxation of real income would insist on indexation, while others might argue that nominal rates of return can adjust in the marketplace (particularly if variations in marginal tax rates from taxpayer to taxpayer can be significantly reduced) to achieve near-neutral results without the pain and complexity of indexing.

Marginal Rate Reduction

The traditional school of tax reform put great weight on elimination of preferential provisions in the tax law. In contrast, other analysts, most notably Milton Friedman and James Buchanan, have argued much more strongly for marginal rate reduction (Friedman 1980; Buchanan and Brennan 1980). The rate reduction argument centers on the likely behavior of taxpayers with respect to preferences under a regime of substantially lower tax rates. Traditional tax reform holds that taxpayers must be prevented from using tax preferences by repealing them from the law. When this is done, the tax base will be broadened, and marginal rates can be reduced without a loss of revenue. In contrast, the rate reduction school would hold that marginal rate reductions depreciate all preferences in the tax code. At marginal rates below some level, taxpayers would simply cease to use those preferences, because they would cease to be profitable at those lower rates. There would be no need to go through the pain of repealing the preferences in the tax code.

The productivity of the rate reduction strategy depends on the share of income that is now taxed at full rates and the degree of tax subsidy available for preferred investments. The experience of the 1981 tax rate cuts was not encouraging. The Accelerated Cost Recovery System (ACRS) and other tax preferences combined to make tax sheltering more, rather than less, profitable. The 1981 and 1982 Internal Revenue Service statistics showed that the entire partnership sector of the economy ran net losses for the first time in the history of the statistics (Piet 1983 and 1984). Given the rest of the tax code, the 1981 rate cuts were not enough to stop tax sheltering and its resultant waste of vital resources.

Could a deeper rate cut in a flat tax leave tax revenues whole without a rewriting of the details of the tax code? Experience cannot answer this question definitively. So whether the flat tax and this branch of tax reform are in harmony must remain a matter of opinion.

Targeted Subsidies

Another definition of tax reform runs almost directly counter to the traditional school, though it leans somewhat on the real economic income point of view. This definition would hold that tax reform is the provision of subsidies to activities that are important to economic growth. Thus, the enactment of ACRS or the expansion of the capital gains exclusion might be called "reform," even though they push the definition of income for tax purposes even farther away from true economic income (Bloomfield 1983). The rationale for this position in the case of income from capital may be that such income is mismeasured during inflation.

The problem with this definition of reform from the traditional view is that it requires outguessing the market—finding and subsidizing activities that would do more for the economy than those that would be selected by the unconstrained operation of the marketplace. This is a tall order for any individual or committee to achieve. Another problem is that whatever the intent of tax subsidies, they always create opportunities for manipulation and avoidance; some of the intended subsidy leaks into tax sheltering schemes, distorting resource allocation and demeaning the income tax itself.

Targeted subsidies and the flat tax would have a tense marriage. Lower rates would reduce revenue in the first instance, and if repeal of existing tax preferences were compromised by the introduction of new ones (or the retaining of selected old ones), the revenue cost could be prohibitive. If flat tax advocates were not satisfied with low and uniform tax rates on all of income, the entire concept would be open to question.

The Budget

There are two schools of thought concerning the budget. To some observers, the budget deficit is paramount. A tax change would be less than a reform if it failed to raise whatever additional revenue was necessary to reduce the deficit to a manageable size. That amount of revenue would be determined in a multipart political process, in which different categories of spending would be examined for politically acceptable and programmatically desirable cuts, and the tax system would be left to make up the difference. Whatever structural improvement of the tax system that could be had at that point would be welcome, but it would be the frosting on the cake in the larger view of things.

According to another point of view, the real issue is the total amount of government spending. Total spending is the real burden on the public, from this viewpoint, and the state of the tax system is at a lower level of concern. This view suggests that tax revenue cuts that force later spending reductions are a real fiscal reform, regardless of the tax policy consequences. Any government deficit that ensues while the public sector is cut down to size is a transitional problem at worst.

How the flat tax fits in this dichotomy is anybody's guess. Proponents of supply-side economics might see a flat tax as a deficit remedy, satisfying the antideficit school. Others might see a modified flat tax as the least distorting and least painful way to raise additional revenues under static economic assumptions. On the opposite side of the street, a low, single-rate tax might be a convenient way to cut federal revenue and force major surgery on the spending side.

Obviously, the deficit is a divisive issue, and when it cross-cuts the tax reform debate it leaves the body politic in a shambles. It is hard to say for certain how the many splinters of these policy positions will come back together, if at all. Public opinion certainly has moved toward a broader tax base and lower tax rates, but the trend is tenuous.

We do not know what the flat tax really is, but we do not know what tax reform is either. The positive connotations of the word "reform" have made it a handy banner for just about any cause. Traditional strains of thought are divided on the appropriate distribution of the tax burden, the proper response to the problem of inflation, and the optimal size of the federal establishment. When the politics of the budget deficit compound these fractures, it is clear that there is no single strong limb to support the flat tax or any other tax policy concept.

Conclusion

This paper should confirm what just about everyone thought already: that the people identified with or supportive of the issues of "tax reform," "the flat tax," or other near-synonyms are far from a coalition, but rather constitute the most loosely knit group of traditionalists, supply-siders, budget cutters, and budget balancers imaginable. They all want economic growth, but they cannot agree on how much they should hope or plan for. They all want a sound fiscal policy, but their conceptions of what that means are all over the lot. They all want low tax rates, but they would cite reasons that are probably mutually inconsistent.

Whenever such a shaky consensus begins to congeal, the members have to ask themselves what really matters, lest the consensus dissipate just as suddenly. In this instance, some policymakers who want a broader tax base as a primary objective, and others who want lower tax rates first and foremost, have found themselves in the same uniforms. There will be the inevitable debates over who got there first and why; but those questions are for after the game. The real issue is where the common ground is and how the unlikely allies can fight together to achieve all of their objectives.

In my opinion, the elemental force behind the recent demand for a new tax policy is fairness—the public's desire for it, and the current tax system's lack of it. The public's complaint is not based on too much or too little rate graduation, though perhaps everyone has a notion of a preferred rate schedule. Rather, the public unrest is based on the current law's lack of integrity and certainty, on its willingness to be bought for the benefit of any group with a lobbyist, a lawyer, and an accountant. The public complains because it perceives that some people need not heed the broad outlines of the law. So long as the tax law does not treat all taxpayers in roughly the same way, it invites noncompliance and abuse, twisting the vicious circle one more turn.

In 1981 the tax legislative process got caught up in a bidding war, with the two sides vying for support by offering a better deal to certain select interest groups. The result was not public satisfaction, but rather a public demand for something different. The same thing could happen again. The groups that had the political power to extract preferences from the current law could continue to press their interests, and the political process could respond to such claims. The result, however, would have the same fundamental flaw that has caused today's drive for change: the preferential treatment of a select few.

It is important that all sides of the flat tax coalition remember that the essential attribute of that tax is a connotation of equal treatment; the "flat" in most people's minds probably characterizes the proverbial playing field more than the rate schedule. A single rate with exceptions for today's favored groups will face the same public hostility as the current law. If the subject of tax shelters remains on the financial page of every daily newspaper, tax reform will have accomplished nothing. A flat tax, modified or otherwise, can reduce tax rates and budget deficits, and it can simplify forms and instructions. But it must command the respect of the taxpayers to be called "reform."

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THE PROGRESSIVE RATE–PROGRESSIVE REVENUE MYTH

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The paper by Minarik (1985) provides a useful discussion of the array of flat tax proposals and of the various interpretations of "tax reform." However, while I found his paper informative, I must criticize him for being far too reticent about what we can say about tax rate impacts. We can go far beyond definitions and "a few subjective observations." As Gwartney and Long (1985) illustrate with econometric evidence, high tax rates can destroy a significant part of the tax base by driving people into tax avoidance activities. Nevertheless, Minarik seems to question the very existence of important incentive or supply-side effects stemming from higher marginal tax rates. He cites no evidence either way when he suggests that one opinion on these matters is about as good as another. I differ strongly with that judgment.

It is critical to note that a market economy is not a zero sum game—Lester Thurow notwithstanding. Market exchange creates value and facilitates specialization, which allows for greater production. In the words of Adam Smith, market exchange is the backbone of the wealth of nations. This is as true today as it was two centuries ago. When oranges from Orlando are traded for wheat from Montana, both the oranges and the wheat gain value, even if no extra oranges or extra wheat is created. But if profits from trading are taxed at 50 percent, less trade will occur.

Higher taxes make trade less attractive and interfere with economic coordination, which can be described as a form of social cooperation. Self-centered activities, being untaxed (hiking, sport fishing, and other "leisure" pursuits), increase at the expense of market activities oriented toward what others might like from us. Our time, our land, our firms are devoted more to activities that please us and less to

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producing value for (and taxable payments from) others in society. Higher tax rates also mean greater tax avoidance activities, so that resources are devoted by taxpayers to avoiding taxes and by government to limiting tax avoidance activity. GNP falls and we are all poorer due to this "excess burden" of higher tax rates. Gwartney and Stroup (1982a) document the large impact, over the decades, that tax rate changes have had on tax avoidance activities.

We can also say far more about the equity impacts of higher tax rates than Minarik chooses to address. The rising tax rates imposed on people already in high tax brackets will shift the burden of taxes in a counterintuitive fashion toward lower income taxpayers. Again, the results of Gwartney and Long (1985) are pertinent. In their study they do not even look at the impact of taxes on gross earnings, but merely at the games people play in converting gross earnings to (a much smaller) net taxable income. At higher tax rates, more tax avoidance games make sense for the individual. But flattening the tax rate structure (lowering the top marginal rates) reduces people's incentive and willingness to undertake costly and complex tax avoidance activities.

Table 1 illustrates how lower tax rates can in fact increase the tax base by so much that revenue actually increases after a tax cut, for upper income taxpayers.[1] The figures from the Kennedy tax cut of 1964 demonstrate the expansive effects on economic activity of a tax

TABLE 1

REVENUE EFFECTS OF THE KENNEDY TAX CUT

Income ($000s)	Marginal Tax Rate Joint Return Top-of-Class Income 1963	1965	Percentage Rise in Adjusted Gross Income	Percentage of Tax Revenue Collected 1963	1965
Under 10	26	22	1.0	48.1	39.9
10–15	30	25	33.0	19.6	21.6
15–50	59	50	32.3	21.1	23.5
50–100	72	60	43.3	6.1	7.4
100–500	91	70	52.1	3.9	5.6
500–1,000	91	70	67.3	0.5	0.8
Over 1,000	91	70	71.6	0.7	1.2

SOURCE: U.S. Department of the Treasury (1963, 1965).

[1]Table 1 is adapted from Gwartney and Stroup (1982b).

cut, and the counter intuitive shifting of the tax burden brought about by an across-the-board tax cut. Of course, by themselves, these numbers are only suggestive. But when combined with figures from other tax cuts, and with the Gwartney-Long cross-sectional results, they are convincing.

The 1964 tax cut reduced everyone's marginal tax rate (tax bracket) by about 22 percent. The cut was roughly uniform, but the effects were not. To see why, it is helpful to look at both the top and the bottom tax brackets. The top tax rate of 91 percent was dropped to 70 percent. But this 22 percent reduction is not the important part of the picture from a taxpayer's point of view. The taxpayer is interested in his take-home income, that is, his income after taxes. For taxpayers in the top bracket, take-home pay from earning another dollar rose dramatically: far more than 22 percent. Before the cut, the taxpayer in the top bracket could take home only 9 cents of an additional (taxable) dollar. But after the cut, the 9 cents figure became 30 cents—a 330 percent increase in the incentive to earn another dollar. By contrast, even though the bottom tax bracket fell from 20 percent to only 14 percent, the change in incentive was rather minor: 80 cents in take-home pay rose to 86 cents, from an additional dollar earned. That was only an 8 percent increase in the incentive to earn another dollar, even though the tax rate itself had been decreased by more than 22 percent.

We can see now why a flatter tax rate structure would substantially increase economic growth, raise more revenue, and in all likelihood redistribute the burden of the income tax, with the rich shouldering more of the load. The burden of the existing, highly progressive tax rate structure is not only very great, it puts a much greater burden on the low income taxpayer than would first appear likely. Again, Table 1 is instructive. Despite the apparent shift of the burden, giving many more dollars in tax breaks to the rich than to low income taxpayers, the rich in fact paid much more in tax revenues after the Kennedy tax cut than before it. Those earning a million dollars and up paid 70 percent more in taxes than before, while the bottom half of all taxpayers paid much less. Given the dramatic shift in incentives faced by the rich, as compared to the small change in incentives facing lower income taxpayers, we should not be surprised.

Buchanan and Lee (1982) have pointed out that these supply-side incentives can be expected to have much greater impacts in the long run than in the short run. Gwartney and I have elsewhere looked at the short-run impacts of tax cuts in the 1920s and 30s, as well as the 1960s, 70s, and 80s (Gwartney and Stroup 1982a, 1982b). All of the short-run effects are roughly in line with the substantial, and at first surprising, effects shown in Table 1. However, the long-run effects are even more dramatic. In 1926, after the Mellon tax cuts, the top rate was only 25 percent. That rate applied to people earning over $100,000. With a top rate of 25 percent, those individuals contributed 50.9 percent, more than half of all tax revenues in 1926. (Before the Mellon cuts, in 1921, people earning that amount faced a 73 percent marginal tax rate, and contributed 28.1 percent of all revenue.) But note that by 1963, the top tax rate had been driven all the way up to 91 percent. Did tax revenues increase from those individuals whose tax rate had risen so much? Emphatically not! Per capita GNP had nearly quadrupled from 1926 to 1963, so that we might expect far more income to those earning the same $100,000 per year (not corrected for inflation). Yet individuals earning over $100,000 in 1963 contributed only 5.1 percent of total tax revenues. At the much higher tax rates, interest groups had developed numerous tax loopholes over the years. The very rich were taxed at much higher rates, but paid less than one-tenth as much revenue.

When the top rate grew from 25 percent to 91 percent, the take-home pay from earning an extra dollar dropped from 75 cents to 9 cents. It does not take a genius to see that when the incentive to earn a dollar falls from 75 cents down to 9 cents, the incentives are dramatically changed. Moreover, there are a great many results of these incentives: activities with bigger payoffs include lobbying for loopholes, hiring tax consultants, taking tax deductible business-related vacations, engaging only in those money-making activities that are fun, and in general enjoying more perquisites that are tax deductible and taking fewer perquisites that must be purchased from after-tax income. The primary activity whose payoff declines when tax rates rise so steeply is profitable commerce. Fruitful exchanges in the marketplace are the main way in which people cooperate. Yet when the government takes 91 percent of the fruits of cooperation, one can safely predict a dramatic reduction in that kind of cooperation. In its place, strictly self-serving activities will thrive. Recreation, hobbies which can be pursued as "businesses," and tax avoidance of all sorts will increase.

Minarik seems to ignore the huge incentive differentials implicit in reducing the highest tax rates, and to ignore the predictable and observed tax revenue results. Consequently, he seems to ignore the toll that higher tax rates take on human cooperation. This, in my judgment, is a tragic mistake. Higher tax rates reduce economic exchange, destroy the tax base, and shift the burden of taxation toward low income taxpayers. To ignore the data examined in the studies cited above, as Minarik does, simply perpetuates the myth that a more progressive tax *rate* structure leads to a more progressive *revenue* result. Policy based on that myth is disastrous. In short, Minarik's paper does not take us very far. We clearly can say a good deal more than he is willing to say about the results of a flatter tax structure.

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