Policy Analysis

Cato Institute Policy Analysis No. 192: The Futility of Raising Tax Rates

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Executive Summary

President Clinton has proposed a major increase in federal income tax rates, especially for the rich. His stated reason for that action is that the rich benefited disproportionately from the tax-rate reductions of the 1980s and thus are not paying their fair share. In fact, lower tax rates in the 1980s led to higher, not lower, revenues from the rich. The top 1 percent of taxpayers ranked by income, for example, paid over 25 percent of all federal income taxes in 1990, compared to less than 18 percent in 1981.

The history of tax-rate increases shows that they seldom produce much revenue. Their principal effect is to make higher taxes on the poor and the middle class more palatable. In fact, because of inflation and real growth of the economy, in just a few years tax rates originally imposed on the rich often apply to those with middle incomes. The rich, meanwhile, often evade higher rates by making increased use of deductions and other legal tax shelters. Moreover, higher rates tend to encourage Congress to add new deductions to the tax code.

The Clinton plan, therefore, is based on false premises and is unlikely to achieve the goal of increasing the tax burden on the wealthy. It will probably lead, instead, to higher taxes on the poor and the middle class, as higher revenues from the rich fail to materialize. In the end, the burden of higher taxes must fall largely on the middle class because that is where the bulk of income is. Thus, maintaining a low top tax rate is the best way to ensure that tax rates remain reasonable for those with low and moderate incomes.

Introduction

During the 1980s the goal of tax reformers on both the left and the right was to reduce marginal tax rates as much as possible. To a large extent, that was accomplished. At the beginning of the 1980s, the top marginal income tax rate was 70 percent; by the end it had fallen to just 28 percent. Moreover, support for low marginal tax rates was so widespread that virtually every major nation on earth followed the U.S. example and cut marginal tax rates in the 1980s. The following are among the reasons for the cuts.

--High marginal rates were producing little revenue.

--High rates led to a proliferation of legal tax deductions, which created complexity and distorted economic decisionmaking, as well as encouraged tax evasion.

--Inflation was pushing many people of moderate means into tax brackets originally intended for the wealthy.

--The growing international mobility of both capital and labor put nations with high tax rates at a competitive disadvantage.

Now President Clinton has proposed a reversal of policy in an economic program that explicitly raises marginal tax rates. A new top rate of 36 percent will apply to single individuals with incomes above $115,000 and to married couples who file jointly and have incomes above $140,000. In addition, a surtax of 10 percent will apply to individuals with incomes above $250,000, raising the effective top rate to 39.6 percent.[1]

Tax Fairness?

It is not entirely clear what the true purpose of Clinton's proposal is; in his original plan, which was part of his campaign, he talked only about "forcing the very wealthy to pay their fair share of taxes."[2] He also expressed concern that during the 1980s "the wealthiest 1 percent of Americans got 70 percent of income gains." Although that "fact" is not related directly to higher taxes, the revenue figures are included in a section entitled "Tax Fairness." Those figures indicate that higher tax rates for the top 2 percent of taxpayers, an increase in the Alternative Minimum Tax, and a surtax on millionaires would raise $82.9 billion over four years (1993-96).[3] In the administration's budget document, those revenues are estimated at $96.8 billion between 1994 and 1997.[4] According to the Department of the Treasury, the proposal "would increase the fairness of the tax system by ensuring that upper income taxpayers pay their fair share of federal income taxes."[5]

None of those rationalizations is a valid justification of higher tax rates. First, it is absurd to say that the rich do not "pay their fair share." The share of federal income taxes paid by those with upper incomes has been rising, not falling. Indeed, the top 1 percent of taxpayers now pay more than one-fourth of all federal income taxes, as shown in Table 1.

Table 1
Share of Total Federal Income Tax Burden by Adjusted Gross Income Percentile (Percent)

Tax Year	Top 1%	Top 5%	Top 10%	Top 25%	50%
1980	19.0	36.8	49.3	73.0	92.9
1981	17.6	35.0	48.0	72.3	92.5
1982	19.0	36.1	48.6	72.5	92.6
1983	20.3	37.3	49.7	73.1	92.8
1984	21.1	38.0	50.6	73.5	92.6
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
1989	25.2	44.0	55.9	77.4	94.3
1990	25.6	44.1	55.8	77.4	94.4

Source: Internal Revenue Service, unpublished data.

The second rationalization is also flawed in several ways. First, the statement that the rich got 70 percent of the income gains in the 1980s is flatly wrong. The source for that assertion was, apparently, a calculation made by Professor Paul Krugman of MIT, which was quoted in the New York Times.[6] According to the Times, Krugman's calculation showed that "60 percent of the growth in after-tax income of all American families between 1977 and 1989--and an even heftier three-fourths of the gain in pretax income--went to the wealthiest 660,000 families, each of which had an annual income of at least $310,000 a year, for a family of four."

That statement, which appeared in early editions of the Times, implies that 60 percent of the aggregate income growth of all Americans went to the top 1 percent of taxpayers. Had that been the case, it would have meant that the top 1 percent of Americans got 60 percent of $830 billion, which was the increase in aggregate after-tax family income in

the United States between 1977 and 1989. According to the Congressional Budget Office, the top 1 percent of taxpayers actually got about one-fourth of the increase in aggregate income during that period. However, the CBO cautions that even the correct figure can be misleading.

The rise in overall income says nothing about whether the average family at any point in the income distribution was better off as a result or how any improvements in well-being were distributed among families. If average family income had not changed, the 27 percent increase in the number of families alone would have increased aggregate income by that percentage or about $580 billion; that amounts to more than two-thirds of the total actual increase.[7]

In fact, Krugman was talking about average income growth. The Times clarified that point in later editions of the same day, although no comment or correction notice ever appeared. The revised editions stated, "An outsized 60 percent in the average after-tax income of all American families between 1977 and 1989--and an even heftier three- fourths of the gain in average pretax income--went to the wealthiest 660,000 families" (emphasis added).[8]

Krugman Analysis Flawed

Table 2
Shares of After-Tax Income and Distribution of Changes in Average Income among Income Categories (percent)

	Krugman			Revised		
Income Category	1977	1989	Gaina	1977	1989	Gaina
Bottom 20 percent	6	4	-11	6	4	-7
Second 20 percent	12	10	-7	11	10	3
Middle 20 percent	16	15	2	15	15	11
Fourth 20 percent	23	22	8	22	21	15
81st to 90th percentiles	16	15	11	16	15	11
91st to 95th percentiles	10	10	10	10	10	8
96th to 99th percentiles	11	12	25	12	13	19
Top 1 percent	7	12	70	8	13	44

Source: Congressional Budget Office, "Measuring the Distribution of Income Gains," CBO staff memorandum, March 1992, pp. 3-4.

aShare of gain in average after-tax income.

Krugman, it turns out, was wrong on several points. First, he apparently made a mathematical error in recalculating some data originally published by the CBO. According to his methodology, the "correct" figure is 70 percent, rather than 60 percent. However, even that number turns out to be wrong because Krugman's methodology failed to adjust for changes in family size over the period. Between 1977 and 1989 average family size declined by 10 percent, with the largest reduction in families in the middle-income quintiles. That is significant because small families need less income than do large families to maintain a given standard of living. Table 2 shows the "correct" data based on Krugman's original methodology and the revised figures adjusted by the CBO for changes in family size. As one can see, the revised data indicate that the rich did much less well than Krugman stated, and the poor and the middle class did much better. Yet, as noted earlier, Governor (now President) Clinton continued to use the incorrect numbers to justify his case for higher taxes on the rich.

Even with all the adjustments, however, the data are still conceptually flawed, insofar as they purport to reflect a redistribution of income from lower income and middle-income Americans to the rich. As Michael Boskin, chairman of President Bush's Council of Economic Advisers, explains:

Mr. Krugman's calculation bears no relation to how gains from economic growth are distributed. Suppose an economy

has two workers with annual incomes of $20,000 and $30,000, respectively. A few years later, these same workers earn $30,000 and $40,000, respectively, and two new workers obtain jobs earning $20,000 each, all figures adjusted for inflation.

Total real income increased by $60,000. One- sixth accrued to the worker now representing the top 25 percent of income earners. One-sixth ac crued to the worker in the next 25 percent of income earners. And two-thirds accrued to the bottom 50 percent of earners.

Average income increased by $2,500 (from $25,000 to $27,500) while average income in the top half of the distribution increased by $5,000 (from $30,000 to $35,000). Mr. Krugman's calculation of the gain in average income would indicate that people in the top half accounted for 100 percent of the gains from economic growth--of the gain in average income--even though the two original workers received equal raises, one moved from the bottom half to the top half of the distribution, and two new workers found jobs and now constitute the bottom half (emphasis in original).[9]

Table 3
Effects of Taxes and Transfer Payments on Household Income by Income Quintile, 1990

Quintile	Before Taxes and Transfers	After Taxes and Transfers
Average Income		
Lowest	$ 2,096	$10,904
Second	14,664	18,676
Third	28,836	27,017
Fourth	45,836	38,780
Highest	93,966	71,944
Income Share (Percent)		
Lowest	1.1	6.5
Second	7.9	11.2
Third	15.5	16.1
Fourth	24.7	23.2
Highest	50.7	43.0

Source: Council of Economic Advisers, Economic Report of the President, 1992 (Washington: U.S. Government Printing Office), p. 136.

It should also be noted that the data Krugman used are for money income; thus, the value of all in-kind government transfers, such as those for Medicaid and public housing, is excluded. Those and other transfers, as well as the tax system, have a substantial effect on income distribution, reducing incomes of the wealthy and increasing those of the poor. Table 3 illustrates that effect.

Last, note that, contrary to Clinton's statement about the 1980s, Krugman was looking at income changes beginning in 1977, well before the beginning of the Reagan Republican era, which Clinton obviously meant to impugn. As the late Warren Brookes and others have shown, the common use of 1977 as a base year for comparison has the effect of making it appear that the Reagan administration was responsible for declining incomes, rising income inequality, and the like, when the Carter administration (1977-80) was actually to blame.[10] In fact, the CBO implicitly admits that bias, as shown in Table 4.

Table 4
Shares of After-Tax Income and Distribution among Income Categories of

Changes in Average Income (Percent)			
Income Category	1977-89a	1980-89	1985-89
Bottom 20 percent	-7	-3	2
Second 20 percent	3	3	12
Middle 20 percent	11	11	15
Fourth 20 percent	15	15	12
81st to 90th percentiles	11	14	12
91st to 95th percentiles	8	8	1
96th to 99th percentiles	19	19	13
Top 1 percent	44	38	37

Source: Congressional Budget Office, "Measuring the Distribution of Income Gains," p. 7.

aShare of gain in average after-tax income.

Taxes and Redistribution

At this point, one might well ask what the chances are that increasing the top federal income tax rate--say, on the top 2 percent, those with incomes over $200,000--will actually achieve the apparent goal of equalizing the distribution of income. Clearly, much redistribution already takes place, as indicated in Table 3. But how much more could be achieved solely on the tax side?

History shows that the ability to extract higher revenues from the rich is extremely limited. Higher rates simply cause the rich to shift their income from taxable forms to nontaxable forms or to forms that are taxed at a lower rate. The former would include tax-free municipal bonds, the latter capital gains.[11] Other probable effects include increased use of deductions already in effect, such as business losses to reduce taxable income, and the growth of tax evasion, both of which have been directly related to marginal income tax rates.[12]

Additional economic effects include a decline in labor supply as those affected by higher tax rates substitute leisure for labor by, for example, retiring earlier.[13] They also shift their compensation from wages to nontaxed benefits, such as pensions and insurance.[14] They shift from wage labor to self-employment, because self-employment provides greater opportunities for tax avoidance and evasion and because they can incorporate and thus pay tax at the corporate tax rate if it is lower.[15] In fact, there is strong evidence that the Tax Reform Act of 1986, by reducing the top individual income tax rate below the corporate rate, encouraged de-incorporation; many corporations became partnerships or Subchapter S corporations, income for both of which is taxed at the individual rather than the corporate tax rate.[16] Presumably, the reverse effect would occur if Congress raised the top individual rate to 39.6 percent (41 percent on earned income) and set the corporate rate at 36 percent. As a result, the revenue yield from any increase in marginal tax rates would be far less than expected.[17]

Figure 1
Top Statutory Income Tax Rate
Measures from 1913-1993
(Graph Omitted)

Figure 1 illustrates the history of the top federal income tax rate since inception of the tax in 1913. As one can see, the top rate began at 7 percent, rose sharply during World War I, and peaked at 77 percent in 1918. The top rate fell during the 1920s, reaching a low of 24 percent in 1929, before rising steadily during the Roosevelt era. The top rate peaked at 94 percent at the height of World War II. The World War II rates stayed relatively intact during the 1950s and did not decline until the Kennedy-Johnson tax cut of the early 1960s, which brought the top rate down to 70 percent. The Reagan tax cuts brought the top rate down to 28 percent.[18] The 1990 budget agreement increased the top rate to 31 percent, where it stands today.[19]

Origin of High Rates

World War I was a godsend for statists of the time, giving them an excuse to raise tax rates far higher than anyone had imagined they could ever go when the income tax was instituted in 1913. As Princeton historian Arthur Link puts it: "Progressives used the necessity for vastly increased revenues as the occasion for putting their . . . tax theories into effect. The new income and inheritance taxes constituted, for that day, a powerful equalitarian attack on great property, unrivaled even by Lloyd George's 'Tax on Wealth' of 1909."[20] Historian Gerald Carson adds, "World War I built an acceptance for the income tax that might have never existed otherwise."[21]

Clearly, wars are the major factors that lead to increases in tax rates and legitimatize tax systems.[22] Even Alexander Hamilton recognized that. As he told Robert Morris in 1781, "The object of the war . . . would supply the want of habit, and reconcile the minds of the people to paying to the utmost of their ability."[23]

Unfortunately, governments never seem to raise rates temporarily for the duration of a war; instead they impose permanent tax increases. It is then difficult to get tax rates back down to their prewar levels. There are always war debts to pay, veterans' benefits to pay, and any number of "pressing social needs" that require the maintenance of wartime tax rates.[24] Albert Gallatin, Thomas Jefferson's treasury secretary, recognized that and urged that all taxes be temporary because otherwise some new purpose for which to spend the money would always be found.[25]

In his 1919 State of the Union message, President Woodrow Wilson recognized that continuation of the wartime tax rates would harm the economy and ultimately reduce government revenues.

The Congress might well consider whether the higher rates of income and profits taxes can in peace times be effectively productive of revenue, and whether they may not, on the contrary, be destructive of business activity and productive of waste and inefficiency. There is a point at which in peace times high rates of income and profits taxes discourage energy, remove the incentive to new enterprise, encourage extravagant expenditures and produce industrial stagnation with consequent unemployment and other attendant evils.[26]

Wilson's treasury secretary, Carter Glass, was equally emphatic about the need for lower taxes. As he stated in his Annual Report for 1919:

The upper brackets of the surtax have already passed the point of productivity, and the only consequence of any further increase would be to drive possessors of these great incomes more and more to place their wealth in the billions of dollars of wholly exempt securities heretofore issued and still being issued by States and municipalities, as well as those heretofore issued by the United States. This process not only destroys a source of revenue to the Federal Government, but tends to withdraw the capital of very rich men from the development of new enterprises and place it at the disposal of State and municipal governments upon terms so easy to them (the cost of exemptions from taxation falling more heavily upon the Federal Government) as to stimulate wasteful and nonproductive expenditure by State and municipal governments.[27]

Throughout 1920 the Wilson administration pressed hard for tax reduction, especially of surtaxes, emphasizing that high wartime rates were actually reducing the government's revenue.[28] However, then as now, congressional Democrats were obsessed with holding on to as much of the people's income as possible, the better to spend it themselves. It was also argued that high statutory tax rates were necessary for reasons of "fairness." As a result, no action was taken, and Republican Warren G. Harding was elected president in 1920, and Republicans picked up many House and Senate seats. In his inaugural address, Harding said that his highest priority was the reduction of wartime tax rates, "which have become unproductive and are so artificial and burdensome as to defeat their own purpose."[29]

During the 1920s tax rates were cut massively, with the amazing result that revenues actually increased, especially from the wealthy.[30] That was due to the vast expansion of the tax base as a result of the general economic expansion of the 1920s that was caused largely by the tax cuts.[31] Table 5 presents data on that point.

Table 5
Federal Income Tax Revenue by Income Class, 1921 and 1926

	Revenue Collected[a]		Percent of Total	
Income Class	1921	1926	1921	1926
Less than $10,000	155.1	32.5	22.5	4.6
$10,000 - $25,000	121.8	70.3	17.6	9.9
$25,000 - $50,000	108.3	109.4	15.7	15.4
$50,000 - $100,000	111.1	136.6	16.1	19.2
Over $100,000	194.0	361.5	28.1	50.9
Total	690.2	710.2	100.0	100.0

Source: James Gwartney and Richard Stroup, "Tax Cuts: Who Shoulders the Burden?" Federal Reserve Bank of Atlanta Economic Review, March 1982, p. 25.

aMillions of constant 1929 dollars.

The Roosevelt Era

The onset of the Great Depression in 1929 led to a sharp decline in tax revenues, as the economy contracted. President Herbert Hoover's response was to push for a major tax increase. The Revenue Act of 1932 raised tax rates across the board, with the top rate rising from 25 percent to 63 percent. That increase was justified on the grounds that the budget needed to be balanced to restore business confidence. Yet the $462 million deficit of 1931 jumped to $2.7 billion by 1932 despite the tax increase. Interestingly, the major cause of the deficit's rise was a sharp decline in income tax revenue, which fell from $1.15 billion in 1930 to $834 million in 1931, $427 million in 1932, and just $353 million in 1933. Moreover, as Table 6 demon- strates, the higher tax rates on the wealthy actually caused the tax burden to be shifted to the nonwealthy.

Table 6
Federal Income Tax Revenue by Income Class, 1931 and 1932

	Revenue Collected[a]		Percent of Total	
Income Class	1931	1932	1931	1932
Less than $25,000	51.6	134.0	21.0	36.5
$25,000 - $50,000	40.1	48.1	16.3	13.0
$50,000 - $100,000	44.8	51.7	18.2	14.1
$100,000 - $300,000	51.9	66.2	21.1	18.0
Over $300,000	57.8	67.4	23.5	18.4

Source: James Gwartney and Richard Stroup, "Tax Cuts: Who Shoulders the Burden?" p. 27.

aMillions of constant 1931 dollars.

Economists today recognize Hoover's tax increase as a terrible blunder, which deepened and prolonged the depression.[32] In the 1932 campaign Franklin D. Roosevelt attacked Hoover for his error. In a speech in Pittsburgh on October 19, for example, Roosevelt blamed the economic malaise on Hoover's tax policy.

Taxes are paid in the sweat of every man who labors because they are a burden on production and are paid through production. If those taxes are excessive, they are reflected in idle factories, in tax-sold farms, and in hordes of hungry people, tramping the streets and seeking jobs in vain. Our workers may never see a tax bill, but they pay. They pay in deductions from wages, in increased cost of what they buy, or--as now--in broad unemployment throughout the land. There is not an unemployed man, there is not a struggling farmer, whose interest in this subject is not direct and vital. It comes home to every one of us![33]

Upon taking office, however, Roosevelt made no effort to reduce taxes but instead pressed for still higher rates on the rich. The 1935 tax bill, in particular, was especially aimed at the very wealthy, despite strong reservations on the part of Roosevelt's advisers that the result would be a deepening of the depression.[34] In the end, the top rate was raised to 79 percent, estate taxes were raised, and a wide variety of other taxes increased as well. How- ever, altogether the bill raised just $250 million.[35] In fact, it was said that only one person in America, John D. Rockefeller, actually paid any tax at the top rate.[36]

The limited impact of the 1935 tax bill in terms of dollars, however, greatly understates its significance. Joseph Schumpeter, for one, believed that the advent of "taxation for taxation's sake and regardless of insignificance of results for the Treasury" would, within a few years, have a seriously negative effect on the economy.[37] In fact, the U.S. economy suffered a sharp setback in 1937. That and Democratic losses in 1938 eventually led to a scale-back of overt "soak-the-rich" tax policies. However, rather than cut rates, Congress expanded tax shelters, thus mitigating much of the redistributive impact of earlier tax bills.[38]

The onset of World War II led to a further increase in tax rates. Of much greater significance, however, was the fact that the vast bulk of the population was required to pay income taxes. Before World War II, the federal income tax had been a very limited tax--on the eve of war fewer than 14 percent of workers even filed returns. By the end of the war, three-quarters of all workers did so.

As noted earlier, wartime tax rates tend not to be reduced afterward. Such was the case with the World War II rates. President Harry S Truman fought the Republican Congress in 1947 and 1948 to prevent any reduction in tax rates. Although modest cuts were finally enacted over his veto, they proved to be short-lived, as the onset of the Korean conflict in 1950 again required an increase in taxes.

Eisenhower and Kennedy

With the election of Republican Dwight D. Eisenhower as president and a Republican Congress in 1952, a golden opportunity to cut the wartime tax rates was created. Unfortunately, Eisenhower believed that taxes could not be cut until the budget was balanced. "We cannot afford to reduce taxes, reduce income," he said, "until we have in sight a program of expenditure that shows that the factors of income and outgo will be balanced."[39]

Although Eisenhower's sentiment was admirable, losses in the 1954 election cost the Republicans control of Congress. The return of Democratic control meant that any chance of reducing wartime tax rates was lost for the balance of the 1950s. It took the election of a Democratic president in 1960 to finally bring that about.

Eisenhower's fiscal conservatism carried a heavy price. There were three recessions during his administration--July 1953 through May 1954, August 1957 through April 1958, and April 1960 through February 1961--and real growth of the gross domestic product averaged just 2.5 percent over those eight years. In large part, that sluggish growth was due to high tax rates, not just on the wealthy but on the middle class as well. In fact, as Figure 2 shows, increasing tax rates on the wealthy led to increases in tax rates on middle-class incomes (defined as $50,000 for a family of four in 1992) as well.[40]

Thus, Democrat John F. Kennedy was able to run as the candidate of growth in 1960, promising to "get the economy moving again." Republican Richard M. Nixon, saddled with the legacy of slow growth during the Eisenhower years, paid the price, loss of a close election.

Figure 2
Increases in Top Rates Lead to Higher Rates on Middle-Class Incomes2
Note: Middle-Class income is defined as $50,000 for a family of four in 1992.2
(Graph Omitted)

Kennedy understood, as Eisenhower had not, that tax cuts have a better chance of bringing about a balanced budget than does the continuation of confiscatory wartime tax rates. He spelled that out in a speech before the Economic Club of New York on December 14, 1962.

Our true choice is not between tax reduction, on the one hand, and the avoidance of large Federal deficits on the other. It is increasingly clear that no matter what party is in power, so long as our national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenue to balance our budget, just as it will never produce enough jobs or enough profits. Surely the lesson of the last decade is that budget deficits are not caused by wild-eyed spenders, but by slow economic growth and periodic recessions, and any new recession would break all deficit records.

In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low, and the soundest way to raise the revenue in the long run is to cut the rates now. The experience of a number of European countries and Japan has borne this out. This country's own experience with tax reduction in 1954 has borne this out. And the reason is that only full employment can balance the budget, and tax reduction can pave the way to that employment. The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring about budget surplus.

I repeat: our practical choice is not between a tax-cut deficit and budgetary surplus. It is between two kinds of deficits: a chronic deficit of inertia, as the unwanted result of inadequate revenues and a restricted economy; or a temporary deficit of transition, resulting from a tax cut designed to boost the economy, increase tax revenues, and achieve--and I believe this can be done--a budget surplus. The first type of deficit is a sign of waste and weakness; the second reflects an investment in the future.[41]

On January 24, 1963, Kennedy sent his tax cut proposal to Congress. It called for reducing the top marginal income tax rate from 91 percent to 70 percent, reducing the lowest income tax rate from 20 percent to 14 percent, and cutting the corporate income tax rate from 52 percent to 47 percent.[42] Interestingly, Kennedy's tax plan was opposed by some of his more liberal advisers, such as John Kenneth Galbraith.[43] They favored stimulating the economy by increasing government spending. But Kennedy held firm, not just on the need for tax cuts, but on cuts in marginal tax rates.

Although he did not live to see his proposal enacted into law, Kennedy's plan passed Congress essentially as proposed in early 1964. Subsequent analysis strongly indicates that, as Kennedy believed it would, the tax cut led to an increase in federal revenue, especially from the rich, and a significant increase in economic growth.[44] The data in Tables 7 and 8 support that view.

Unfortunately, the positive economic effects of the Kennedy tax cut were not long-lived. The outbreak of inflation in the late 1960s pushed people into higher tax brackets and thus increased average marginal tax rates. Figure 3 shows the relentless growth of the average marginal tax rate for all taxpayers.[45]

Table 7
Estimated and Actual Federal Receipts, 1964-67 ($ Billions)

Year	Estimated	Actual	Difference
1964	$109.3	$112.7	+$3.4
1965	115.9	116.8	+0.9
1966	119.8	130.9	+11.1
1967	141.4	149.6	+8.2

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

Table 8
Tax Revenue from the Wealthy, 1961-66 ($ Millions)

Income Class	1961	1962	1963	1964	1965
$100,000 - $500,000	1,970	1,740	1,890	2,220	2,752
$500,000 - $1 million	297	243	243	306	408

Over $1 million	342	311	326	427	603

Source: Michael K. Evans, The Truth about Supply-Side Economics (New York: Basic Books, 1983), p. 199.

Despite few legislated tax increases during the late 1960s and 1970s, rising inflation and lack of indexing meant that higher nominal incomes pushed taxpayers into higher and higher tax brackets. The result was, as theory predicts, an increase in tax evasion and avoidance, which shrank the tax base.[46] For that reason, many economists predicted that a cut in tax rates had the potential to expand the tax base by reducing the incentive to evade or avoid taxation and thereby increasing government revenue.

Although the notion that a tax cut might increase revenue is often derided, we have already seen evidence from the 1920s and 1960s that tax cuts do, indeed, increase revenue. Conversely, tax increases may lose revenue. As John Maynard Keynes put it:

Figure 3
Average Marginal Tax Rate, 1916-83
Source: Barro and Sahasakul
(Graph Omitted)

Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more--and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you were already making a loss.[47]

When Ronald Reagan was elected president in 1980, his principal campaign promise was to cut tax rates. In 1981 that promise was fulfilled, and the top marginal income tax rate was reduced from 70 percent--where it had been since Kennedy's day--to 50 percent. Taxpayers in other tax brackets received similar rate reductions. Although it is often asserted that the Reagan administration predicted an increase in revenue from that tax cut, all revenue figures released by the Reagan administration followed standard revenue-estimating procedures, which assumed a dollar of revenue loss for every dollar of tax "cut."[48] Nevertheless, considerable research has been done on the revenue effects of the Reagan program, including the effects of the Tax Reform Act of 1986, which lowered the top rate from 50 percent to 28 percent, and there is strong evidence that revenues from the wealthy did, indeed, increase.[49]

Although the Clinton administration assumes substantial revenues will be generated by an increase in the top rate, as Clinton's campaign documents did, the evidence from theory and history strongly suggests that projected revenue targets will not be met. Not only will a higher top rate encourage tax evasion and avoidance, but higher tax rates will raise the cost of capital, thus lowering investment and increasing unemployment in the long run. Recent analyses of Clinton's campaign proposals support that view.[50] As a consequence, it is now widely reported that higher tax rates for the rich may not necessarily raise much revenue.[51]

Conclusion

President Clinton's proposal to raise taxes on the rich is based on false premises:

The rich got richer in the 1980s at the expense of the poor and the middle class.

That was the result of Reagan's tax cuts, which also caused revenue from the wealthy to fall.

Higher tax rates will both increase government revenue from the rich and redistribute income from the rich to the poor and the middle class.

In fact, the rich did not getter richer at the expense of anyone. All income classes benefited from the prosperity of the 1980s. Moreover, the data on which Clinton has relied to support his proposal are deeply flawed.

In addition, authoritative data from the Internal Revenue Service clearly demonstrate that the tax cuts of the 1980s led to higher, not lower, revenues from the rich. Both logic and the experience of history strongly suggest that the opposite result would occur if tax rates were increased.

Last, there is no evidence that higher taxes on the rich would do anything to benefit the economic position of the poor and the middle class. On the contrary, there is strong evidence that higher taxes on the rich would eventually lead to higher taxes on the middle class.

Notes

[1] Actually, the top rate on earned income (wages and sala ries) would be even higher because Clinton has proposed eliminating the current $135,000 cap on the 1.45 percent Medicare tax. Thus, for earned income, the top rate would be over 41 percent. Moreover, for married couples filing separately, the threshold for the surtax would be only $125,000.

[2] Bill Clinton and Al Gore, Putting People First: How We Can All Change America (New York: Times Books, 1992), p. 4.

[3] Ibid., p. 31.

[4] Office of Management and Budget, A Vision of Change for America (Washington: U.S. Government Printing Office, 1993), p. 139.

[5] Department of the Treasury, Summary of the Administra tion's Revenue Proposals (Washington: Department of the Treasury, 1993), p. 34.

[6] Sylvia Nasar, "Even among the Well-Off, the Richest Get Richer," New York Times, March 5, 1992. It was later re ported that when Clinton saw that figure in the Times, he "went crazy," according to his press secretary Dee Dee Myers. See Sylvia Nasar, "However You Slice the Data the Richest Did Get Richer," New York Times, May 11, 1992.

[7] Congressional Budget Office, "Measuring the Distribution of Income Gains," CBO staff memorandum, March 1992, p. 2.

[8] The first quote appeared in editions of the New York Times distributed in the Washington area. The second quote is from the article as it now appears in a Nexis printout. Subsequently, Krugman published several articles explaining what he had said or meant to say in the first place. See Paul Krugman, "Disparity and Despair," U.S. News & World Report, March 23, 1992, pp. 54-55; idem, "Ignorance and Inequality," U.S. News & World Report, June 1, 1992, pp. 48- 49; and idem, "The Right, the Rich, and the Facts," American Prospect, no. 11 (Fall 1992): 19-31.

[9] Michael Boskin, Letter to the editor, Wall Street Journal, July 3, 1992.

[10] See Warren Brookes, "Hiding a Boom in a Statistical Bust," Wall Street Journal, August 6, 1987; and idem, "Try ing to Blame Carter on Reagan," Washington Times, February 8, 1988. The Clinton administration is continuing the fraud; see Office of Management and Budget, pp. 7, 18.

[11] Throughout most of U.S. history, capital gains have been taxed at a lower rate than ordinary income. It is widely believed that the differential was abolished by the Tax Reform Act of 1986. However, the 1990 budget agreement, which raised the top income tax rate from 28 percent to 31 percent, fixed the maximum capital gains tax at 28 percent. Even that small increase, however, has been enough to moti vate tax-shelter activity by wealthy individuals who, in effect, convert ordinary income into capital gains. That trend will certainly accelerate in the future, given the Clinton administration's proposal to keep the maximum capi tal gains tax rate at 28 percent.

[12] See James Long, "Tax Rates and Tax Losses: A Preliminary Analysis Using Aggregate Data," Public Finance

Quarterly 12, no. 4 (October 1984): 457-72; Charles Clotfelter, "Tax Eva sion and Tax Rates: An Analysis of Individual Returns," Review of Economics and Statistics 65, no. 3 (August 1983): 363-73; Roger Waud, "Tax Aversion and the Laffer Curve," Scottish Journal of Political Economy 33, no. 3 (August 1986): 213-27; Richard McKenzie, "The Micro and Macro Eco nomic Effects of Changes in the Statutory Tax Rates," Review of Social Economy 31, no. 1 (April 1973): 20-30; James Alm, Roy Bahl, and Matthew N. Murray, "Tax Structure and Tax Compliance," Review of Economics and Statistics 72, no. 4 (November 1990): 603-13; and Steven Crane and Farrokh Nourzad, "Tax Rates and Tax Evasion: Evidence from Califor nia Amnesty Data," National Tax Journal 43, no. 2 (June 1990): 189-99.

[13] Jerry Hausman, "Labor Supply," in How Taxes Affect Eco nomic Behavior, ed. Henry Aaron and Joseph A. Pechman (Wash ington: Brookings Institution, 1981), pp. 27-64; and Harvey Rosen, "What Is Labor Supply and Do Taxes Affect It?" Ameri can Economic Review 70, no. 2 (May 1980): 171-76.

[14] James E. Long and Frank Scott, "The Income Tax and Nonwage Compensation," Review of Economics and Statistics 64, no. 2 (May 1982): 211-19; Stephen A. Woodbury, "Substi tution between Wage and Nonwage Benefits," American Economic Review 73, no. 1 (March 1983): 166-82; James E. Long and Frank A. Scott, Jr., "The Impact of the 1981 Tax Act on Fringe Benefits and Federal Tax Revenues," National Tax Journal 37, no. 2 (June 1984): 185-94; and Frank Sloan and Killard W. Adamache, "Taxation and the Growth of Nonwage Compensation," Public Finance Quarterly 14, no. 2 (April 1986): 115-37.

[15] James E. Long, "Income Taxation and the Allocation of Market Labor," Journal of Labor Research 3, no. 3 (Summer 1982): 259-76.

[16] Roger H. Gordon and Jeffrey K. Mackie-Mason, "Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form," in Do Taxes Matter? ed. Joel Slemrod (Cambridge, Mass.: MIT Press, 1990), pp. 91-131; Myron S. Scholes and Mark A. Wolfson, "The Role of Tax Rules in the Recent Restructuring of U.S. Corporations," in Tax Policy and the Economy, vol. 5, ed. David Bradford (Cambridge, Mass.: MIT Press, 1991), pp. 1-24; James M. Poterba, "Why Didn't the Tax Reform Act of 1986 Raise Corporate Taxes?" in Tax Policy and the Economy, vol. 6, ed. James M. Poterba (Cambridge, Mass.: MIT Press, 1992), pp. 43-58.

[17] Edgar K. Browning, "Elasticities, Tax Rates, and Tax Revenue," National Tax Journal 42, no. 1 (March 1989): 45-58.

[18] Due to the phase-out of some deductions, some people paid a marginal rate of 33 percent. However, for those with the highest incomes, 28 percent was the top rate.

[19] Although 31 percent is the top statutory rate, because of anomalies in the interaction of various features of the tax code, some people may actually pay as much as 52 percent federal income tax on each additional (marginal) dollar earned, according to some experts. See Philip J. Harmelink and Phyllis V. Copeland, "'Hidden Taxes' through Phaseouts and Floors: Assessment and Policy Implications," Tax Notes, January 4, 1993, p. 83.

[20] Arthur Link, Woodrow Wilson and the Progressive Era, 1910-1917 (1954; reprint, New York: Harper Torchbooks, 1963), pp. 195-96.

[21] Gerald Carson, The Golden Egg: The Personal Income Tax, Where It Came From, How It Grew (Boston: Houghton Mifflin, 1977), p. 106.

[22] See Edward Ames and Richard T. Rapp, "The Birth and Death of Taxes: A Hypothesis," Journal of Economic History 37, no. 1 (March 1977): 161-78; C. Northcote Parkinson, The Law and the Profits (Boston: Houghton Mifflin, 1960), pp. 38-50; and Bruce D. Porter, "Parkinson's Law Revisited: War and the Growth of American Government," Public Interest, no. 60 (Summer 1980): 50-68.

[23] Quoted in Dall W. Forsythe, Taxation and Political Change in the Young Nation, 1781-1833 (New York: Columbia University Press, 1977), p. 51.

[24] The Democrats on the House Ways and Means Committee, for example, colorfully described their opposition to the tax reduction bill of 1921 as follows:

What an impregnable position would it be and what an appeal it would make to the sense of right and justice of the people for the Democrats to take the position that not a dollar of taxes should be reduced on these profiteering corpora tions and on the millionaires and multimillion aires that reaped harvests of wealth during the war, as long as there is a single disabled or wounded soldier or a single widow or orphan of a dead soldier or a single veteran in need (emphasis in original).

In U.S. Congress, House of Representatives, "Minority Views," Report no. 350, part 2, 67th Cong., 1st sess., p. 4.

[25] Quoted in Forsythe, p. 53.

[26] Congressional Record, 66th Cong., 2d sess., December 2, 1919, vol. 59, part 1, p. 53.

[27] Annual Report of the Secretary of the Treasury on the State of the Finances, for the Fiscal Year Ended June 30, 1919 (Washington: U.S. Government Printing Office, 1920), p. 24.

[28] See Annual Report of the Secretary of the Treasury on the State of the Finances, for the Fiscal Year Ended June 30, 1920 (Washington: U.S. Government Printing Office, 1921), pp. 25-47.

[29] Congressional Record (April 12, 1921), p. 170.

[30] For details, see Randolph E. Paul, Taxation in the United States (Boston: Little, Brown, 1954), pp. 131-42; John F. Witte, The Politics and Development of the Federal Income Tax (Madison: University of Wisconsin Press, 1985), pp. 88-96. Interestingly, one historian has concluded that the Republican tax policies of the 1920s were based essen tially on proposals generated by Wilson's Treasury Depart ment. Thus, at least at the presidential level, there was far more continuity on tax policy between Wilson and the subsequent Harding, Coolidge, and Hoover administrations than is commonly believed. See Lawrence L. Murray, "Bureau cracy and Bi-partisanship in Taxation: The Mellon Plan Re visited," Business History Review 52, no. 2 (Summer 1978): 200-25.

[31] Robert B. Ekelund, Jr., and Mark Thornton, "Schumpeterian Analysis, Supply-Side Economics and Macroeconomic Policy in the 1920s," Review of Social Economy 44, no. 3 (December 1986): 221-37. See also Benjamin G. Rader, "Fed eral Taxation in the 1920s: A Re-examination," Historian 33, no. 3 (May 1971): 415-35.

[32] E. Carey Brown, "Fiscal Policy in the 'Thirties: A Reap praisal," American Economic Review 46, no. 5 (December 1956): 857-79; and Herbert Stein, The Fiscal Revolution in America (Chicago: University of Chicago Press, 1969), pp. 26-38.

[33] The Public Papers and Addresses of Franklin D. Roose velt, vol. 1, The Genesis of the New Deal, 1928-1932 (New York: Random House, 1938), p. 798.

[34] Raymond Moley, After Seven Years (New York: Harper & Brothers, 1939), pp. 310-11.

[35] Roy G. Blakey and Gladys C. Blakey, "The Revenue Act of 1935," American Economic Review 25, no. 4 (December 1935): 676.

[36] Mark Leff, The Limits of Symbolic Reform: The New Deal and Taxation, 1933-1939 (New York: Cambridge University Press, 1984), p. 145.

[37] Joseph A. Schumpeter, Business Cycles, 2 vols. (New

York: McGraw-Hill, 1939), vol. 2, p. 1039.

[38] Thomas M. Renaghan, "Distributional Effects of Federal Tax Policy, 1929-1939," Explorations in Economic History 21, no. 1 (January 1984): 50-56.

[39] Public Papers of the Presidents of the United States: Dwight Eisenhower, 1953 (Washington: U.S. Government Print ing Office, 1960), p. 12.

[40] As F. A. Hayek has argued, the main purpose of high statutory tax rates on the wealthy is to justify higher tax rates on the masses than they would otherwise be willing to tolerate. Hayek, The Constitution of Liberty (Chicago: University of Chicago Press, 1960), p. 311.

[41] Public Papers and Addresses of the Presidents of the United States: John F. Kennedy, 1962 (Washington: U.S. Government Printing Office, 1963), pp. 879-80. See also Eco nomic Report of the President, 1963 (Washington: U.S. Gov ernment Printing Office, 1963), p. xiv.

[42] Public Papers and Addresses of the Presidents of the United States: John F. Kennedy, 1963 (Washington: U.S. Government Printing Office, 1964), pp. 73-92.

[43] Arthur Schlesinger, A Thousand Days (Boston: Houghton Mifflin, 1965), pp. 648-50, 1003-4; John Kenneth Galbraith, Ambassador's Journal (Boston: Houghton Mifflin, 1969), p. 381; and Otto Eckstein, "The Economics of the 1960's--A Backward Look," Public Interest, no. 19 (Spring 1970): 89-90.

[44] Among the many economic analyses of the Kennedy tax cut are the following: Council of Economic Advisers, Economic Report of the President, 1965 (Washington: U.S. Government Printing Office, 1965), pp. 65-66; Arthur M. Okun, "Measuring the Impact of the 1964 Tax Reduction," in Perspectives on Economic Growth, ed. Walter W. Heller (New York: Random House, 1968), pp. 25-49; Lawrence R. Klein, "Econometric Analysis of the Tax Cut of 1964," in The Brookings Model: Some Further Results, ed. James S. Duesenberry et al. (Chi cago: Rand McNally, 1969), pp. 459-72; U.S. Congress, House Committee on the Budget, Joint Economic Committee, and Con gressional Research Service, Economic Stabilization Poli cies: The Historical Record, 1962-76, Joint Committee Print, 95th Cong., 1st sess. (Washington: U.S. Government Printing Office, 1978), pp. 6-9, 15-19, 70-91; and Victor A. Canto, Douglas Joines, and Robert Webb, "The Revenue Effects of the Kennedy Tax Cuts," in Foundations of Supply-Side Economics: Theory and Evidence, ed. Victor A. Canto, Douglas Joines, and Arthur Laffer (New York: Academic Press, 1983), pp. 72-103.

[45] Data are for the income tax only and are taken from Robert J. Barro and Chaipat Sahasakul, "Average Marginal Tax Rates from Social Security and the Individual Income Tax," Journal of Business 59, no. 4, part 1 (October 1986): 562-63.

[46] James D. Gwartney and Richard Stroup, "Marginal Tax Rates, Tax Avoidance, and the Reagan Tax Cut," in Supply- Side Economics in the 1980s: Conference Proceedings (Westport, Conn.: Quorum Books, 1982), pp. 197-209.

[47] The Collected Writings of John Maynard Keynes, vol. 9, Essays in Persuasion (London: Macmillan, 1972), p. 338.

[48] See White House, A Program for Economic Recovery (Wash ington: U.S. Government Printing Office, February 18, 1981), p. 7.

[49] Daniel R. Feenberg and James M. Poterba, "Income In equality and the Incomes of Very High Income Taxpayers: Evidence from Tax Returns," Working Paper no. 4229, National Bureau of Economic Research, Washington, December 1992; Lawrence B. Lindsey, The Growth Experiment (New York: Basic Books, 1990); U.S. Congress, Joint Economic Committee, Fair ness and the Reagan Tax Cuts, 98th Cong., 2d sess. (Washing ton: U.S. Government Printing Office, 1984); and U.S. Con gress, Joint Economic Committee, Tax Reform, Tax Rates, and Tax Revenues, 99th Cong., 1st sess. (Washington: U.S. Gov ernment Printing Office, 1985).

[50] Even the Joint Committee on Taxation, which is con trolled by the Democratic majority of Congress, has estimated much lower revenues from raising the top rate than has the Clinton Treasury. See David Rogers, "Revised Figures on Deficit Spur Search for Cuts," Wall Street Journal, March 4, 1993; and Eric Pianin and Steven Mufson, "Clinton Economic Plan Gains Support," Washington Post, March 4, 1993. See also Aldona Robbins and Gary Robbins, "Bill Clinton's Eco nomic Plan," Policy Backgrounder no. 120, National Center for Policy Analysis, Dallas,

1992; and Republican Staff, Joint Economic Committee, "Putting People Out of Work: First-Year Growth and Employment Effects of the Clinton Economic Plan," August 1992, Mimeographed.

[51] Sylvia Nasar, "Tapping the Rich May Prove Tricky," New York Times, December 12, 1992; and Brett Fromson and John Mintz, "The Hitch in Taxing the Rich," Washington Post, November 29, 1992.