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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THE ECONOMICS AND POLITICS OF TAX REFORM

Richard Gephardt

Introduction

Politicians have talked about tax reform forever. Everybody is for it, but most also have this or that little exception—the little deduction that they do not want you to touch. While there is a lot of interest in talking about tax reform, I am not sure how much interest there is in actually doing something. When you do something, there must be a specific proposal that actually says, "these deductions are in and those are out, and this is the rate structure."

It all really reminds me of a story I recently heard about a fellow in a particular town who was having great luck fishing. He was coming home with garbage buckets full of fish. It became an item of discussion throughout the county and much of the state. There were newspaper articles about it. Finally people talked about it to the point that the local game commissioner decided he had better investigate how in the world this person could be so lucky. So the commissioner began to investigate, to talk to people, trying to find out what kind of lures the fisherman was using. When the commissioner was walking down Main Street of the fisherman's home town, this fellow came up to him, hit him on the shoulder, and said, "I know why you're here and I have nothing to hide. In fact, the best way for you to find out how I do it is to go fishing with me."

The commissioner thought, "Well, this is the fastest way to find out." So they got in this fellow's car, went out to the local lake, jumped in the fisherman's boat, and raced out to the middle of the lake. The fisherman shut off the motor, reached under his seat, pulled out a stick of dynamite, lit it and threw it into the water. A huge explosion

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