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National Center for Policy Analysis

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Budget Summit Issue:

SHOULD INCOME TAX RATES FOR WEALTHY TAXPAYERS BE INCREASED?

"The federal government collects more tax revenue today than in 1980, but at much lower tax rates."

Background. Lower personal income tax rates are Ronald Reagan's most significant legacy. The highest rate was 70 percent in 1980. Tax reform in 1981 reduced it to 50 percent and in 1986 to the 28 percent that prevails today. Although tax rates are much lower, the federal government now collects more revenue (as a percent of GNP) than it did in 1980.

Current Tax Rates. An unusual feature of the tax code is that upper-income taxpayers pay a marginal tax rate of 33 percent, while the wealthiest taxpayers face a marginal rate of only 28 percent:[1]

- For a single taxpayer, the 33 percent tax rate applies to income between $47,050 and $97,620.

- For a joint return, the 33 percent rate applies to income between $78,400 and $162,770.

Note: This anomaly applies only to *marginal* tax rates (the tax paid on the last dollar of income). Total taxes paid always rise as income rises. The more you earn, the more taxes you pay.

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"The 33 percent 'bubble' for upper-middle-income taxpayers is caused by the phase-out of the personal exemption and the 15 percent tax rate."

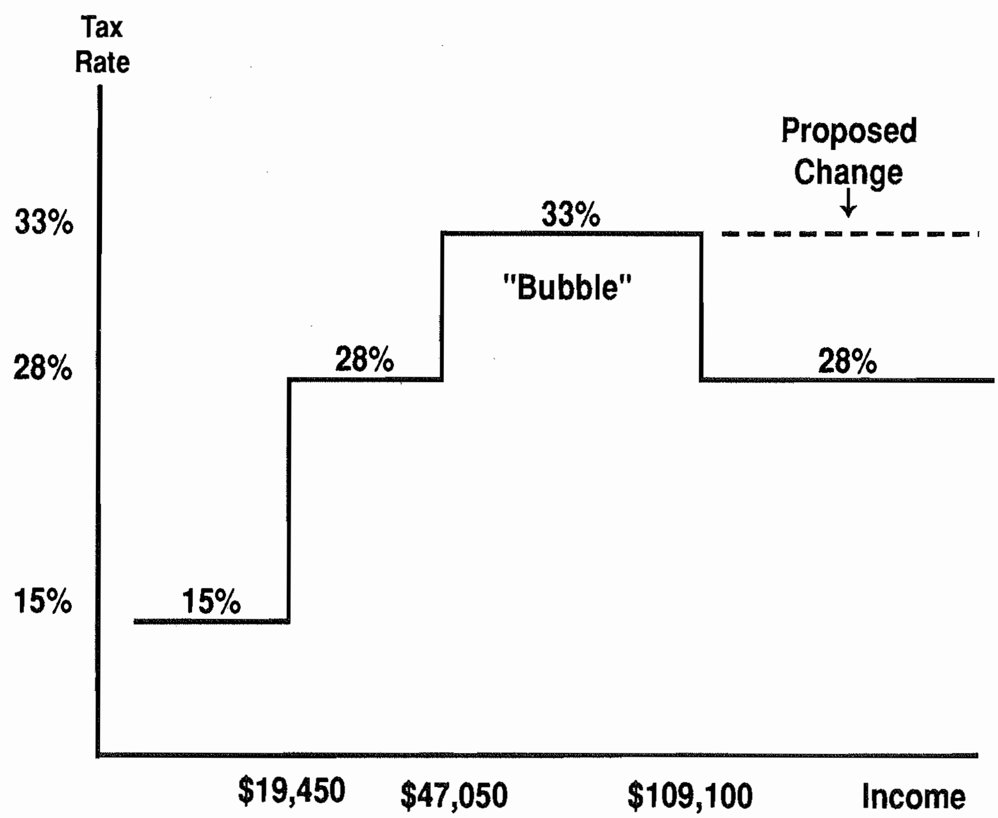
How The Tax Law Currently Works. There are only two tax brackets in today's tax code: 15 percent and 28 percent.[2] However, above a certain level of income, taxpayers must pay an additional 5 cents for each additional $1 of income. This additional 5 cent tax is designed to "take back" the value of the personal exemption and the lower 15 percent rate for higher-income taxpayers. The result is that some people pay a 33 percent *marginal* tax rate on some of their income — a feature of the tax code often called the "bubble."[3] Once the take-back is completed, all *additional* income is taxed at the marginal rate of 28 percent. [See graphic.]

"The proposal would increase the tax burden for the wealthy by almost 18 percent."

Proposed Change: A 33 Percent Tax Bracket for the Wealthy. Some Congressional Democrats argue that the 33 percent tax rate should be applied to *all* the income of wealthy taxpayers. Under the proposal, single taxpayers earning more than $97,620 and couples earning more than $162,770 would face a five percentage point increase in their marginal tax rates. Their total tax burden would increase by almost 18 percent.

"The budget package may contain a 33 percent tax bracket for the wealthy."

MARGINAL INCOME TAX RATES FOR A SINGLE TAXPAYER



Arguments For the Change. Proponents argue that the change is justified on grounds of fairness and the need for greater federal revenue. The wealthy, they argue, can and should pay higher tax rates than people who are less wealthy. Moreover, income taxes on the rich are fairer than consumption or "sin" taxes, which hit low and moderate-income families harder. Proponents also argue that the change will generate about $53 billion in revenue over the next five years and about $145 billion over the next ten years.

Arguments Against the Change. Opponents argue that the proposal would reverse the effects of the Reagan economic program — causing less economic growth and capital formation. As a result, a net increase in federal revenue would occur only in the first few years. Beyond that, federal revenue actually would *decrease* because lower economic growth would reduce tax collections. Opponents also argue that the proposal would harm private sector economic activity, reducing everyone's income in the long run.

"Historically, increases in the highest marginal tax rate have always led to lower total taxes paid by the wealthy."

What History Shows. The evidence indicates that the wealthy have enormous discretion over how and when to realize income, and whether to realize it at all. At high tax rates, they can convert taxable income into fringe benefits or other business expenses. High tax rates also cause people to work less, save less and invest less. Historically, whenever the highest tax rate has been increased, the tax base (reported income subject to the tax rate) has shrunk so much that total federal revenue from wealthy taxpayers has actually decreased. Whenever the highest tax rate has been reduced, the tax base has expanded so much that total federal revenue from the wealthy has actually increased. For example:[5]

- Between 1921 and 1926 the highest tax rate fell from 73 percent to 25 percent. Although the tax rates of people earning more than $100,000 (1929 dollars) fell by almost two-thirds, their share of total federal income tax revenue rose from 28 percent to 51 percent.

- In 1931 the top marginal tax rate was increased from 25 percent to 63 percent. Yet the share of total taxes paid by people earning more than $100,000 (1931 dollars) fell from 47 percent to 36 percent.

- In 1963 when the top tax rate was 91 percent, the top 5 percent of taxpayers paid 35.6 percent of all income taxes. By 1965, when the top rate had been lowered to 70 percent, the top five percent of taxpayers paid 38.5 percent of all income taxes.

"Tax cuts in the early 1980s caused the wealthy to pay a greater share of total taxes."

Tax Cuts During the 1980s. Virtually all economists believe that the tax rate reductions of the 1980s caused behavioral change and stimulated economic activity. Harvard economist (and current White House advisor) Lawrence Lindsey estimates that 70 percent of the static revenue loss from the 1981 tax reduction was regained through economic expansion.[6] Tax payments by wealthy taxpayers during the 1980s also were consistent with earlier periods. Consider the 1981 reduction in marginal tax rates:[7]

- The top 0.1 percent of all taxpayers (about $200,000 or more of income) saw their share of total taxes rise from 7 percent in 1981 to 14 percent in 1986.

- The top 2 percent of taxpayers (more than $60,000 of income) saw their share of taxes rise from 26 percent to 34 percent.

The 1986 tax reform was a mixed blessing. While the new law *lowered* marginal income tax rates, it *raised* the rate on capital gains. Preliminary estimates indicate that taxes paid on wages and salary income by the wealthy have increased substantially, but this increase may be offset by a huge drop in capital gains tax payments.[8] Both responses are consistent with historical experience.

Forecasting the Effect of a 33 Percent Tax Bracket: Harm to the Economy. Because the current income tax rate of 28 percent is so much lower than the rates that have prevailed in the past, we do not expect an increase in the tax rate to *reduce* tax payments by the wealthy. We do expect a dynamic reaction, however. Lawrence Lindsey estimates that an increase in tax rates from 28 percent to 33 percent will reduce the tax base by at least 5 percent and possibly 10 percent or more.[9]

"In trying to impose a 33 cent tax on a dollar of income, the government would actually collect as little as 29.7 cents."

- If the tax base is reduced by 5 percent, the attempt to impose a 33 cent tax on $1 of income actually would produce only 31.5 cents (95¢ x 33%) of revenue.

- If the tax base is reduced by 10 percent, a 33 cent tax would produce only 29.7 cents (90¢ x 33%) of revenue.

"A 33 percent tax bracket would cause GNP to be $518 billion lower over the next decade."

"For each $1 of new taxes collected from the wealthy, GNP would be reduced by $7.67."

"Government revenues would increase through 1993, but decrease in later years."

In either case, the tax increase would cause considerable economic harm. Taxpayers would be worse off, not only because of higher taxes, but also because their income would be lower. For each $1 of taxes, the private sector would lose anywhere from $2.43 to $6.88. The gain to government would be only a fraction of the cost to the private sector.

Using a different methodology, former U.S. Treasury economists Aldona and Gary Robbins have estimated the effects of a 33 percent tax bracket on the U.S. economy over the next decade:[10]

- Between 1990 and the year 2000, the imposition of a 33 percent tax bracket would reduce GNP by $518 billion.
- The economy would generate 377,000 fewer jobs.
- The U.S. capital stock would be $604 billion lower than otherwise by the year 2000.

Cost of Collecting the Tax. Like the Lindsey analysis, the Robbins' study imply that the 33 percent tax would be very expensive to collect. Over the next decade, the wealthy would pay $67.5 billion in additional taxes. But GNP would be reduced by $518 billion. This means that for each $1 of taxes collected from the wealthy, GNP would be reduced by $7.67.

Forecasting the Effect of a 33 Percent Tax Bracket: Short-Run Revenue Gains, Long-Run Revenue Losses. The Robbins' study also forecasts the effects on federal revenues over the next decade. In the short run (through 1993), the higher bracket will *increase* federal revenue. Over the long term, however, federal revenues will actually *decrease* because of the negative impact of the new tax on the U.S. economy. [See Table.]

- Over the next five years, a 33 percent tax bracket would increase federal revenue by $13 billion.
- Yet between now and the year 2000, the federal revenue would *decrease* by $22 billion.
- State and local governments would lose revenue in every year and would suffer four times the revenue loss of the federal government over the next decade.

"The proposal would cost the federal government $22 billion in revenue through the year 2000."

"Revenue losses for state and local governments would be four times as high as the loss for federal government."

EFFECT OF A 33 PERCENT TAX BRACKET

($ billions)

Year	Change in Federal Revenue	Change in State and Local Revenue
1990	+ $7.5	- $0.8
1991	+ 5.6	- 2.4
1992	+ 3.2	- 4.0
1993	+ 1.1	- 5.6
1994	- 1.4	- 7.4
1995	- 3.0	- 8.6
1996	- 4.5	- 9.8
1997	- 5.8	- 11.0
1998	- 7.1	- 12.0
1999	- 8.2	- 13.1
2000	- 9.4	- 14.2
Total	- $22.0	- $88.9

Source: Aldona Robbins and Gary Robbins, "Will Raising Taxes Reduce the Deficit?," Institute for Policy Innovation, IPI Policy Report No. 105, May 1990.

Why Economic Forecasts Differ: Static Vs. Dynamic Assumptions. The Reagan economic program was based on the idea that changes in tax rates cause people to change their behavior. At lower tax rates, people have incentives to work harder and produce more income. They also have incentives to engage in less tax avoidance and tax evasion. Thus at lower tax rates there will be more income to tax, while at higher tax rates there will be less.

"The static forecasts of major government agencies assume taxes do not affect economic behavior."

These insights are accepted by almost all professional economists. Yet they typically are not incorporated into the economic forecasts of federal government agencies. For example, the Congressional Budget Office (CBO), the Joint Committee on Taxation (JCT) and even the U.S. Department of the Treasury usually publish forecasts that ignore dynamic behavioral adjustments to changes in tax rates.[4] These forecasts are based on *static* rather than *dynamic* assumptions.

The implicit premise behind static forecasts is that tax rates do not affect people's behavior. A static forecast begins by projecting the income people are expected to earn at *current* tax rates and multiplying the tax rate increase by the projected income. If the assumptions of static analysis were correct, higher tax rates would always produce more total revenue. At the extreme, federal revenue would reach its highest level with a 100 percent tax rate! Most economists, however, believe that a 100 percent tax rate would collect *no* revenue. If people were not allowed to keep any of their income, they would have no incentive to earn any income.

Why Economic Forecasts Differ: The Effects on Economic Growth. Static analysis makes another implicit assumption: that tax rates on the wealthy are solely an issue between the federal government and wealthy taxpayers. The rest of us have no reason to care (except insofar as we benefit from increased government revenues). Once we admit that tax rates paid by the wealthy affect their behavior, however, *all* of us have a reason to care.

- If high tax rates cause people to earn less income, there will be less saving, less investment and less economic growth — and *everyone's* income will be lower.

- If economic growth is lower, less will be collected in *all* federal taxes, including Social Security (FICA) taxes, corporate income taxes and federal excise taxes.

- If economic growth is lower, state and local revenue will be affected more adversely than federal revenue.

"A static forecast assumes taxes have no effect on the economy."

"In the long run, a 33 percent tax bracket would make everyone worse off."

EFFECT ON FEDERAL REVENUE
OF A 33 PERCENT TAX BRACKET
1990 through 2000
($ billions)

Type of Tax	Static Forecast	Dynamic Forecast
Personal Income Tax	+$144.5	+$67.5
Social Security (FICA) Tax	0	- 44.4
Corporate Income Tax	0	- 36.5
Other Federal Taxes	0	- 8.3
Total	+ $144.5	- $22.0

Source: Aldona Robbins and Gary Robbins, "Will Raising Taxes Reduce the Deficit?," Institute for Policy Innovation, IPI Policy Report No. 105, May 1990.

Reversing the Effects of Tax Reform. Ronald Reagan's tax revolution quickly became an international phenomenon. Virtually every other country has reduced its highest personal income tax rates or announced its intention to do so. Moreover, most economists believe that lower tax rates have played an important role in stimulating the economy in the 1980s. A 33 percent tax bracket would reverse many of the economic benefits of tax reform. The wealthy would pay more in total taxes. But, in the long run, other taxpayers, the economy and even the federal government would be worse off.

John C. Goodman
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FOOTNOTES

[1]Figures assume no dependents.

[2]These generalizations do not apply to the middle-income elderly, whose tax rates are 50 percent higher as a result of the Social Security benefit tax. See John C. Goodman and A. James Meigs, "The Elderly: People the Supply-Side Revolution Forgot," National Center for Policy Analysis, NCPA Policy Report No. 135, February 1989; and Aldona Robbins and Gary Robbins, "Taxing the Savings of Elderly Americans," National Center for Policy Analysis, NCPA Policy Report No. 141, September 1989.

[3]See the analysis in Aldona Robbins and Gary Robbins, "Will Raising Taxes Reduce the Deficit?" Institute for Policy Innovation, IPI Policy Report No. 105, May 1990.

[4] For an example of how these agencies ignore dynamic adjustments, see Aldona Robbins and Gary Robbins, "The Bush Savings Plan," National Center for Policy Analysis, NCPA Policy Report No. 152, June 1990.

[5]Calculations by James Gwartney and Richard Stroup. Reproduced in Yale Brozen, "The Cost of Bad Government," National Center for Policy Analysis, NCPA Policy Report No. 122, August 1986.

[6]Lawrence Lindsey, *The Growth Experiment* (New York: Basic Books, 1990).

[7]Ibid., p. 83.

[8] See Lawrence Lindsey, "Did ERTA Raise the Share of Taxes Paid by Upper-Income Taxpayers? Will TRA be a Repeat?" in Lawrence H. Summers, *Tax Policy and the Economy* (Cambridge: MIT Press, 1988).

[9]Lindsey, *The Growth Experiment*, pp. 92 and 247.

[10]Robbins and Robbins, "Will Raising Taxes Reduce the Deficit?"

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ABOUT THE NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute, funded exclusively by private contributions. The NCPA originated the concept of the Medical IRA (which has bipartisan support in Congress) and merit pay for school districts (adopted in South Carolina and Texas). Many credit NCPA studies of the Medicare surtax as the main factor leading to the the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, a capital gains tax cut would increase federal revenue, and the federal government gets virtually all the money back from the current child care tax credit. These forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free-enterprise health care task force report, representing the views of 40 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. The NCPA discovered that:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

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> ***Industry Week***