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Soak the rich? How about this: Drive GDP

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"Tax the rich, feed the poor, till there are no rich no more - I'd love to "
. . . change the world, but I don't know what to do.

- From "I'd Love to Change the World," Ten Years After (1971)

While capturing a growing sentiment of some of today's politicians, at least Alvin Lee and his Woodstock-era band mates seemed to concede that they didn't fully understand the economics of taxation. While virtually all of us believe high earners should contribute significantly to tax revenues, we need to ask:

Does "soaking the rich" by increasing individual income tax rates really produce more tax revenue? The answer may surprise you.

First of all, the rich are already pretty well "soaked." In 2008, the top 10% of earners paid 70% of all individual income taxes. Would it be fairer if they paid 80%? If so, would raising tax rates on them achieve that percentage increase?

In his April 14, 2011, Wall Street Journal article, Alan Reynolds of the Cato Institute shared his research, which showed that despite wide swings in the highest tax rates over the years, the ratio of individual income tax receipts to Gross Domestic Product (basically total U.S. revenues) has always remained at about 8%.

President Barack Obama's hope that increasing tax rates on high earners will increase revenues well above that 8% is just that - hope. It's not reality. It has been tried repeatedly over the last six decades and always failed.

From 1952 to 1979, when top rates ranged from 70% to 92%, the individual income tax brought in only 7.8% of GDP. So, whether the motivation for raising taxes is income redistribution or deficit reduction, it doesn't work.

Why is this the case? Given certain tax rates, taxpayers will organize their affairs in a way that manages the amount of taxes they pay. Currently, top tax rates are as follows: individual income (35%), capital gains (15%), qualified dividends (15%), and corporate income (35% - highest of the developed countries). Business owners can choose to operate as normal corporations or partnerships, they can claim a large salary or they can take the compensation for their efforts as capital gains or dividends. If all else fails, they can defer income until later years in hopes that the tax rates will be lower. And there's this: Raising taxes inevitably drives down GDP.

All of these choices have consequences in terms of tax economics.

Some folks like to point to the Clinton administration as the shining star of federal economics. In fact, individual income tax revenues reached an unprecedented 9.6% of GDP from 1997 to 2000. So what happened? Stock prices soared with the market bubble, Congress reduced the capital gains tax rate from 28% to 20%, and, in response, a lot of taxpayers sold their stock and paid substantial taxes. The greatest contribution Bill Clinton made in his second term was that he did not veto the capital gains tax reduction legislation.

The current administration fancies referring to their tax rate increase proposal as the "Buffet Tax," citing the fact that Warren Buffett pays taxes at a rate below that of his secretary. Truth be told, Buffet chooses to claim most of his income at the lower capital gains or dividends rate. The majority of high-earners are paid salaries and often bonuses, and pay taxes at the 35% rate. When state income and other taxes are added, many pay a marginal tax bill closer to 50% of income. If Warren Buffett were forced to report his income as a salary or bonus, his position might be quite different.

The result is similar at the state level, but for a different reason. In 2008, Gov. Martin O'Malley of Maryland pushed through his own version of a millionaires' tax. He contended that his plan for income redistribution would produce an additional $106 million in revenue. In fact, state revenues went down by 25%. What happened? One-third of Maryland's high earners left the state. The Wall Street Journal estimated that O'Malley's "soak the rich" attempt cost his state almost $1 billion in revenues.

So if raising taxes on the rich does not work, how do we increase tax revenues, create jobs and reduce the federal deficit? The answer is clear. If individual income tax revenues average 8% of GDP, and GDP drives job creation, what we need to do is increase GDP.

One of the most effective ways of driving output is to add investment capital to the economy. There are currently trillions of dollars in cash on the balance sheets of U.S. corporations. Some of this cash is in America and some is held offshore. All of this cash could be turned into investment capital if corporations were so inclined. The offshore dollars are not being brought back into the U.S. because to do so would expose them to the highest corporate tax rate in the world. This is effectively an incentive to invest capital in other countries. The enemy of investment capital is uncertainty. As long as politicians are talking about high taxes, bigger government and more stifling regulations, that money will continue to sit on the sidelines.

So if increasing tax revenues is dependent upon increasing GDP, what strategies would be most effective? We should reduce or eliminate the prohibitive tax on bringing cash back into the U.S. That done, we should reduce taxes while eliminating loopholes and subsidies (the Solyndra debacle has proved that government does a poor job of picking winners). Finally, we should trim the size of government and reduce regulations (including government-run health care) that discourage capital investments. Capital is the fuel that powers the economy, and we should do everything in our power to get it in the tank if we want to increase tax revenues and job creation.

I saw a recent poll of Occupy Wall Street protesters that found that the vast majority of them could not identify the top individual tax rate. I am sure almost none of them realize that raising that rate is not likely to produce more revenue for the government. So while "soak the rich" pleas may be more emotionally satisfying, demands to "drive GDP now" would be more effective.