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Obama's Soak-the-Rich Tax Hikes Won't Work

By Alan Reynolds

President Obama's response to congressional efforts to curb runaway federal spending is to emphasize, once again, his resolve to greatly increase tax rates on married couples whose joint incomes are above $250,000. This insistent desire to raise taxes—which he repeated in a speech yesterday while complaining about "trillions of dollars in . . . tax cuts that went to every millionaire and billionaire in the country"—is a distraction. It won't solve our nation's fiscal problem.

Preliminary estimates from the Congressional Budget Office (CBO) project that federal spending under the president's 2012 budget plan would average 23.3% over the coming decade—up from 19.7% in 2007 and 18.2% in 2001.

Even if the president could persuade Congress to enact all of his proposed tax increases, in addition to surtaxes already included in ObamaCare, the CBO finds we would still face endless budget deficits averaging 4.8% of GDP.

"Federal debt held by the public would double under the President's budget," says the CBO, "growing from $10.4 trillion (69% of GDP) at the end of 2011 to $20.8 trillion (87% of GDP) at the end of 2021, adding $9.5 trillion to the nation's debt from 2012 to 2021."

And yet, enormous as they are, these deficit and debt estimates assume that the higher tax rates called for under the president's 2012 budget plan do no harm to the economy, that interest rates stay unusually low, and that the economy avoids recession for a dozen years. Those assumptions require taxpayers to behave much differently than they ever have before.

The revenue estimates are even more unbelievable. According to the Office of Management and Budget, total revenues would supposedly exceed 19% of GDP after 2015, rising to 20% by 2021—a level briefly reached only at the height of World War II (1944-45) and the pinnacle of the tech-stock boom (2000). Moreover, these unprecedented revenues would supposedly come from the individual income tax, which is even less plausible.

It is not as though we have never tried high tax rates before. From 1951 to 1963, the lowest tax rate was 20% to 22% and the highest was 91% to 92%. The top capital gains tax rate approached 40% in 1976-77. Aside from cyclical swings, however, the ratio of individual income tax receipts to GDP has always remained about 8% of GDP.

The individual income tax brought in 7.8% of GDP from 1952 to 1979 when the top tax rate ranged from 70% to 92%, 8% of GDP from 1993 to 1996 when the top tax rate was 39.6%, and 8.1% from 1988 to 1990 when the highest individual income tax rate was 28%. Mr. Obama's hope that raising only the highest tax rates could keep individual tax receipts well above 9% of GDP has been repeatedly tested for more than six decades. It has always failed.

Federal revenue from the individual income tax exceeded 9% of GDP only eight times in U.S. history—during World War II (9.4% in 1944), the recessions of 1969-70, 1981-82 and 1991-92, and the tech-stock boom-bust of 1998-2001. Revenues were a high share of GDP during the three recessions because GDP fell.

The situation of 1997-2000 was unique. Individual income tax revenues reached an unprecedented 9.6% of GDP from 1997 to 2000 for reasons quite unlikely to be repeated. An astonishing quintupling of Nasdaq stock prices coincided with an extraordinary proliferation of stock options, which the Federal Reserve's Survey of Consumer Finances found were granted to 11% of U.S. families by 2001, and with a reduction in the capital gains tax to 20% from 28%, which encouraged much greater realization of taxable gains through stock sales. Revenues from the capital gains tax rose to 10.8% of all individual income tax receipts in 1997 and 13% by 2000. The unexpected revenue windfalls in President Bill Clinton's second term were largely a consequence of lower tax rates on capital gains.

Using IRS data, Thomas Piketty of the Paris School of Economics and Emmanuel Saez of the University of California at Berkeley have estimated that realized capital gains accounted for just 13%-22% of reported income among the top 1% of taxpayers from 1988 to 2006, when gains were taxed at 28%—but that fraction swiftly reached 29%-32% in 1998-2000, when the capital gains tax fell to 20%.

The average tax rate of such top taxpayers was mechanically diluted by the greatly increased realizations of capital gains after 1997 and 2003, since a larger share of reported income consisted of capital gains. Yet the amount of taxes paid by top taxpayers reached record highs for the same reason—there was more revenue to be had from taxing many gains at a low rate than from taxing fewer gains a high rate. Nobody can be forced to sell assets in taxable accounts. To complain that a low tax on realized capital gains is "unfair" is to suggest it would be fairer for affluent investors to sit on unrealized gains, as though an unpaid tax is morally superior to one that collects billions.

As a result of the conventional confusion between tax rates and revenues, some stories in the media have abetted the delusion that the huge gap between spending and likely revenues could be narrowed by simply increasing the highest tax rates on capital gains and/or dividends.

A recent cover story in Bloomberg Businessweek by Jesse Drucker, "The More You Make, the Less You Pay," reported that, "For the well-off, this could be the best tax day since the early 1930s. . . . For the 400 U.S. taxpayers with the highest adjusted gross income, the effective federal income tax rate—what they actually pay—fell from almost 30% in 1995 to just under 17% in 2007, according to the IRS."

Among the top 400 taxpayers (rarely the same people from one year to the next), the average tax rate fell to 22.3% in 2000, when the capital gains tax was 20%, from 29.9% in 1995 when the capital gains tax was 28%. But that same IRS report also shows that real tax revenues from the top 400 more than doubled after the capital gains tax fell, rising to $11.8 billion in 2000 from $5.2 billion in 1995, measured in 1990 dollars.

The same thing happened after 2003, when the capital gains tax was further reduced to 15%. The average tax rate of the top 400 fell to 16.6% in 2007 from 22.9% in 2002. Even though there was no stock market boom as in 1997-2000, real revenues of the top 400 nevertheless doubled again—to $14.5 billion in 2007 from $6.9 billion in 2002. Instead of paying less when the capital gains tax rate went down in 1997 and 2003, the top 400 instead paid much, much more.

The trendy talking point of blaming projected deficits on "tax cuts for the rich" is flatly absurd.

Both individual income taxes and overall federal taxes have long been a surprisingly constant percentage of GDP—8% and 18%, respectively— regardless of top tax rates on salaries, small business and investors. It follows that the only reliable way to raise real federal revenues over time is to raise real GDP.

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