## Four Facts About Taxes

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Early in 1996, when Steve Forbes was running for president, the so-called flat tax received a lot of attention. I say "so-called" because the term is misleading. Flat seems to imply that everyone pays the same amount of tax, but the flat tax is really a proportional tax on all income above some threshold. During the current 105th Congress, both major parties will likely propose changes in the income tax structure. A strong case can be made for moving away from our graduated tax system toward a proportional system. I use the term graduated instead of progressive to describe a tax system in which higher-income people pay higher tax rates because the word progressive smuggles in the idea that a graduated tax is somehow morally superior. Here are four facts that, together, help make the case for a proportional tax rate.

1. High marginal tax rates cause economic harm.

A theorem in economics indicates that the harm caused by a tax--economists call this harm the deadweight loss--is directly proportional to the square of the tax rate. This means a tax rate of 40 percent causes not twice but four times the harm caused by a 20 percent rate. Taxes create harm by causing people not to produce or not to work as much. Take married women: if their husbands earn high incomes, these women can face marginal tax rates of more than 50 percent. Their husbands' income puts them in tax brackets ranging from 28 percent to 39.6 percent; in addition, they pay state income tax rates ranging from 5 percent to 10 percent and Social Security and Medicare taxes of 7.65 percent (15.3 percent if they're self-employed). A married woman considering a job that pays $20,000 a year could plan on taking home less than half of that.

Small wonder, then, that many married women choose not to work outside their homes. Berkeley economist Nada Eissa found that more women worked and many women already employed worked longer hours when the Tax Reform Act of 1986 reduced their marginal tax rates. Based on her estimates, the deadweight loss from the current high tax rates on married women is about 46 cents per dollar of revenue to the government.

2. High tax rates also cause tax avoidance.

People defer the realization of capital gains, take pay in the form of untaxed benefits, buy more expensive houses with bigger mortgages, and buy municipal bonds. All of these activities increase when marginal rates increase.

That cuts in tax rates would have this "dynamic" effect was the supply-siders' key insight in the late 1970s. Although many economists, including me, pooh-poohed the empirical significance of that insight, the evidence from the 1981 Reagan tax cut forced us--or should have forced us--to eat plenty of crow. The best study to date of that cut is by Lawrence Lindsey, now a governor of the Federal Reserve System. In his book The Growth Experiment, Lindsey makes two main points. First, although the tax cut caused tax revenues to be lower than otherwise, they didn't fall nearly as much as a static analysis would have shown; whereas the static revenue loss to government would have been $114.9 billion by 1985, the true loss was only $33 billion. In other words, more than 70 percent of the static revenue loss was made up by a dynamic revenue gain. Second, according to Lindsey, the cuts in the highest tax rates for the highest-income taxpayers, those earning $200,000 a year or more, actually increased the amount of tax they paid. The reason: they declared more taxable income--buying taxable corporate bonds, for example, instead of tax-free municipals--took fewer deductions, and took more of their income in cash rather than in untaxed benefits.

Although the top rate has crept up to 39.6 percent during the Bush and Clinton administrations, it is still well below its stratospheric pre-Reagan level of 70 percent. Thus, a further reduction is unlikely to cause nearly as large a dynamic revenue gain as the 1981 cuts caused. That is why, in recommending a 15 percent cut in tax rates, Bob Dole's economic advisers predicted a substantial reduction in revenue. They were right to do so. Republican vice presidential candidate Jack Kemp, who deserves credit for pushing tax cuts as early as 1976, is simply not credible now in saying that cuts in tax rates would boost revenues.

3. Making tax rates the same for everyone would likely reduce the demand for government spending.

Today, demagogues can get away with telling people that they can have more government without more taxes because "the rich" will pay. Then the demagogues discover, if they didn't already know, that even if the rich did nothing to avoid taxes, there aren't enough of them to pay for the additional programs. The demagogues then urge lower- and middle-income people to go along because at least the rich people will pay the majority of additional taxes. Clinton used this strategy in 1993. Think how far he would have gotten had there been only one tax bracket. Each person would know that--to the extent the program is funded by income tax revenues--he or she would have to pay along with everyone else.

4. Most people, not just high-income people, think a proportional tax on income is more fair than a graduated tax with higher rates for higher-income people.

A few years ago, a petitioner asked a high-income friend of mine to sign a petition to put a graduated income tax on the ballot in Massachusetts. The state constitution required a proportional tax. "Why do you think higher-income people should be taxed at higher rates?" my friend asked the petitioner. "Because," she answered, "people who make more money should pay more in tax." "Right," answered my friend. "If I make five times as much as you, then my taxes should be five times as high as yours." "We agree," said the woman. "Now will you sign my petition?" "No," answered my friend. "If you agree with me, then you should oppose higher tax rates for higher-income people. I now pay five times as much in tax as someone with one-fifth my income. With your proposal, I would pay ten times as much."

The story is interesting for two reasons. First, the woman pushing for a graduated tax system didn't understand what such a system is. Second, this woman's basic sense of justice, although she didn't realize it, implied that the just tax was a proportional tax. She's not alone. When a recent Reader's Digest poll asked what percent of their income a family of four making $200,000 should pay in all taxes to all levels of government--income taxes, Social Security taxes, sales taxes, property taxes, and so forth--the median response of virtually all income and demographic groups was that the maximum should be 25 percent. That hypothetical family, incidentally, now pays 39 percent.

So whether you care about reducing the inefficiency of taxes, making people pay a known share of the cost of the government programs they advocate, or basing the tax system on a widely accepted view of fairness, the proportional tax beats the graduated tax hands down.