Written by **Bob Adelmann** on March 20, 2012

Is Ryan's Budget Plan Headed in the Right Direction?

There were other features to Ryan's proposal, of course: vouchers for Medicare recipients, and spending cuts to balance the budget by the year 2040. And of course, Ryan's bill has no chance of passage. Said Ryan: "We don't expect to make law this year, but we expect to give the country an alternative choice for the future." Ryan's plan echoes proposals by Republican presidential candidates Rick Santorum and Mitt Romney, who also want to reduce and simplify the tax code, but is a far cry from the initial first-year $1 trillion cuts proposed by candidate Ron Paul (with a balanced budget in the second year of his first term).

The Heritage Foundation gave Ryan's proposal an initial approval, saying that it largely met its own criteria for what needs to be done to rein in the government:

> Does it cut spending sharply and quickly?
>
> Does it begin decisive entitlement reform?
>
> Does it avoid any tax hikes?
>
> Does it ensure a strong national defense?
>
> Does it contain pro-growth tax reforms?
>
> Does it move swiftly and surely to a balanced budget?

No, says the Heritage Foundation, but it comes close: "It should be bolder in implementing entitlement reforms [and] it should strive for more aggressive spending reductions. It is slow to reach balance, largely the consequence of avoiding Social Security reforms and slowly phasing in health entitlement reforms."

Although Ryan's plan has yet to be analyzed by the Congressional Budget Office (CBO), it is clear that part of the dynamics of the proposal rests upon higher economic growth that will generate additional revenues without enacting tax hikes. This is why the bill is dead in the Senate: It flies in the face of current progressive ideology, facing charges that it is "unfair" and appears to give high earners a tax break.

History show exactly the opposite: Lower tax rates *increase* the amount of taxes paid by the wealthy because they find it more profitable to move wealth that is currently sheltered from high tax rates into more profitable, and taxable, ventures. A study by Gene Smiley, professor at Marquette University, proves the point.

When the 16th Amendment was passed in 1913 to allow the imposition of income taxes, the marginal tax rate was one percent of income above $4,000. By 1918, it was six percent. Incomes above $25,000 were taxed initially at two percent, but rose to 23 percent while incomes above $100,000 were initially taxed at five percent and then increased to 60 percent. Those earning $750,000 or more were initially taxed at seven percent but found themselves being taxed at 76 percent by 1918.

By 1925, those rates had been drastically reduced so that the highest marginal tax rate was 25 percent and that was only levied on incomes of $100,000 and above. By the late 1920s only about one American in eight was paying any income tax at all. What was the net result? As Smiley noted:

> With the reduction in rates in the twenties, higher-income taxpayers reduced their sheltering of income and the number of returns and share of income taxes paid by higher-income taxpayers rose. For example, the share of total personal income taxes paid by taxpayers with net incomes of $1,000,000 or more rose from 5.75 percent in 1923 to 15.9 percent in 1927. For taxpayers with net incomes of $250,000 to $500,000 their share of total personal income taxes rose from 6.82 percent in 1923 to 12.40 percent in 1927. The share for taxpayers with net incomes of $100,000 to $250,000 rose from 15.7 percent in 1923 to 21.91 percent in 1927. However, *taxpayers with net incomes of $25,000 or less paid 36.22 percent of all personal income taxes in 1923 but only 12.83 percent in 1927. Thus, cutting tax rates effectively shifted the tax burden from the lower-income taxpayers toward the higher income taxpayers….* [Emphasis added.]
>
> Thus, this evidence suggests that the dramatic tax cuts associated with moving toward a flatter rate tax structure would not provide windfalls of income for the wealthier taxpayers. It would encourage them to shift wealth from tax-sheltering investments to taxable investments to receive larger after-tax returns. The movement of economic activity out of lower return tax sheltering into higher return taxable assets will create more efficiency and make people in the society better off.

But what about government revenues? Wouldn't cutting tax rates as proposed by Rep. Ryan reduce tax revenues thereby exacerbating the very problem — increasing deficits — that his plan is supposed to solve? Again, evidence from the 1920s shows just the opposite: Government revenues actually increased as tax rates were reduced. The government not only did not suffer declines, but it generated budget surpluses during those years that allowed the government to pay off some 25 percent of its indebtedness incurred during the First World War.

Resistance to, or ignorance of, such history forms the nearly impenetrable resistance to Ryan's plan. As Smiley said, "The tenacity with which supporters of progressive tax rates cling to this idea is indicative of their redistributionist philosophy. It also indicates their refusal to face reality. The tax cuts of the twenties … resulted in an effective shift of the tax burden from lower- to higher-income taxpayers [and] it does not have to worsen the government's deficit."

The bad news is that Ryan's proposal is DOA. The good news is that it's headed in the right direction.

Photo of Paul Ryan: AP Images