Taxes: Soaking the Rich Hurts Rich and Poor Alike

In a book, Benjamin Anderson tells the story of how a wealthy entrepreneur reacted to the imposition of much higher income-tax rates in 1935 at the bottom of the Great Depression. Anderson's *Economics and the Public Welfare*, a highly regarded study of the Great Depression, was based on his personal experience as an economist for the Chase Manhattan Bank and the editor of the *Chase Economic Bulletin*. Anderson recounts the case of one rich man who,

> at the age of 25, had inherited an estate of about $12 million — some thirty years before these 1935 taxes came. He had nursed his $12 million into an estate of about $30 million during those thirty years.

He had done it by a kind of activity particularly helpful and useful to the country….

He had taken many risks, knowing that many of them would turn out badly, but counting on a few of them to turn out well enough so that the profits on the successful ones would offset the much more numerous losses on the unsuccessful ones….

In the individual … a vigorous man fifty-five years old, the effects of the new taxes were paralyzing. More than three-fourths of any profits which he might have [made] from a new venture would be taken away from him by income taxes. Any losses which he might incur … would be his own.

But further, if he should die, his estate would have to pay the federal government and to the state of New York … $19,602,500, or 65.342 percent of the estate. How could an estate pay this tax if it were spread out in new ventures, in assets for which no ready market existed, in assets which could not be liquidated without great loss?

It was a painful thing to watch him turn his energies from creative production to consultation with tax lawyers as to how he could save as much as possible for his heirs. It was a painful thing to watch a vigorous man of fifty-five turning from creative activities to preparation for death….

He withdrew as far as possible from illiquid investments, and turned to investments of a high degree of liquidity.

Anderson then made a most pertinent observation: "One may well raise the question as to just what good it did to the people of the United States to put this typical man in this position."

What good, indeed? Right at the very bottom of the worst depression the country had experienced since its founding was an entrepreneur with capital and a willingness to risk it in an attempt to gain profits in ventures which, had they proven successful, would have hired the very people most dreadfully impacted by that depression. Instead, he withdrew from the markets altogether, and retired.

By refraining from taking such risks he didn't diminish his lifestyle by any measurable amount. He continued to enjoy a prosperous living, moving to his country estate to live out the remainder of his life. There was little "trickle-down" effect from his living well to be enjoyed by those serving his needs.

Certainly nothing to compare to the possible dozens, perhaps hundreds, of jobs his successful ventures might have created had he been allowed to make money by investing his money. The potential for significant improvement in the lives of those he might have hired was simply eliminated altogether.

Such are the perverse consequences of enforcing a philosophy of punishing wealth creators by redistributing their wealth to others in the name of fairness and equity and egalitarianism.

Economist Thomas Sowell spelled out the benefits of allowing wealth creators to take their risks, which are significant: “Money invested in new business ventures is first paid out to employees, suppliers and contractors. Only some time later, *if the business is profitable*, does money return to the business owners — but in the absence of a profit motive … this activity does not occur.” (Emphasis added.)

George Reisman, in his *Capitalism: A Treatise on Economics*, explained the failure of such redistributionist attempts to spread the wealth from the wealthy to others: Without capitalism there wouldn’t be any wealth to distribute:

> The workers of the early nineteenth century did not lack automobiles and television sets because the capitalists were keeping the whole supply to themselves. There simply were no automobiles or televisions — for anyone.

President Warren Harding knew that the restoration of an economy wracked by depression would be dependent precisely on those risk takers who, if they were allowed to, would be the engines driving the recovery from it.

The Depression of 1920-21 was the sharpest economic contraction in the previous 140 years, with industrial production dropping by *one-third* and unemployment *doubling* from January 1920 to July 1921. Automobile production fell an astonishing 60 percent while wholesale prices cratered by nearly 40 percent.

Harding took the advice of his treasury secretary, Andrew Mellon, who concluded that higher tax rates would drive capital underground or into tax-free securities whereas lower taxes would draw capital into the marketplace where it could put people back to work. Harding cut taxes ferociously, bringing the top rate down from 73 percent in 1921 to 25 percent in 1925. He cut government spending equally aggressively, from $18.5 billion in 1919 to $6.4 billion in 1920 and then further to $3.3 billion in 1922.

The economy leapt upward, and by 1923, it had returned to full employment, scarcely two years after the depression began. As Sowell explained in his short essay *“‘Trickle Down Theory’ and ‘Tax Cuts for the Rich’,”*

> In 1921, when the tax rate on people making over $100,000 a year was 73 percent, the federal government collected a little over $700 million in income taxes, of which 30 percent was paid by those making over $100,000.

By 1929 … the federal government collected more than a billion dollars in income taxes, of which 65 percent was collected from those making over $100,000.

Even more remarkable was the fact that as tax rates fell, “both the amount and the proportion of taxes paid by those whose net income was no higher than $25,000 went *down* between 1921 and 1929, while both the amount and the proportion of taxes paid by those whose net incomes were between $50,000 and $100,000 went up — and the amount and proportion of taxes paid by those whose net incomes were over $100,000 went up even more sharply.”

The lesson is simple: Reducing taxes on the wealthy results not only in the wealthy paying more in income taxes, rather than less, but those less well-off paying less.

In bringing the legacy of "Silent Cal" — President Calvin Coolidge — to light from obscurity, author Amity Shlaes wrote in *The American* that Coolidge continued the legacy of frugality begun by Harding after he died in the summer of 1923:

> Under Coolidge the federal debt fell. Under Coolidge the top income tax rate came down by half, to 25 percent. Under Coolidge the federal budget was always in surplus. Under Coolidge unemployment was 5 percent or even 3 percent….

Under Coolidge Americans wired their homes for electricity and bought their first cars or household appliances on credit. Under Coolidge the economy grew strongly, even as the federal government shrank.

Can you say "Roaring Twenties"? As Coolidge himself said,

The wise and correct course to follow in taxation and all other economic legislation is not to destroy those who have already secured success but to create conditions under which everyone will have a better chance to be successful.

To prove the point, economist Veronique de Rugy wrote,

> The rising tide of strong economic growth lifted all boats. At the top end, total income grew as a result of many more people becoming prosperous, rather than a fixed number of high earners getting greatly richer. For example, between 1922 and 1928, the average income reported on tax returns of those earning more than $100,000 increased 15 percent, but the number of taxpayers in that group *almost quadrupled*. During the same period, the number of taxpayers earning between $10,000 and $100,000 *increased 84 percent*, while the number reporting income of less than $10,000 *fell*. [Emphases added.]

Unfortunately those lessons in fiscal sanity were lost when the Great Depression began in 1929. The top income-tax rate in 1932 began at Coolidge's 25 percent but President Herbert Hoover, dismayed by the enormous drop in revenues and the resulting federal deficit, raised the top tax rates to an astounding 63 percent, dropping the country into the worst depression in its history. As Robert Murphy noted: "The next year, because of Hoover's desire to close the budget hole, the top income tax rate was [raised to] 63 percent. Given this extraordinary single-year rate hike, it is no wonder that 1933 was the single worst year in U.S. economic history."

It took years for the economy to recover, a history that is beyond the scope of this article to explore. But when John F. Kennedy was elected president in 1960, he was still faced with an underperforming economy. In one of his most memorable speeches, Kennedy addressed the Economic Club of New York on December 14, 1962, noting the economy's continuing failure to perform at its maximum:

> In the last two years we have made significant strides. Our gross national product has risen eleven percent, while inflation has been arrested. Employment has been increased by one-point-three million jobs. Profits, personal income, living standards — all are setting new records. Most of the economic indicators for this quarter are up and the prospects are for further expansion in the next quarter.

But we must look beyond the next quarter, or the last quarter, or even the last two years. For we can and must do better, much better than we've been doing for the last five-and-a-half years….

Utilization of existing plant and equipment could be much higher — and, if it were, investment would rise. We need not accept an unemployment rate of five percent or more, such as we have had for 60 out of the last 61 months. There is no need for us to be satisfied with a rate of growth that keeps good men out of work and good capacity out of use.

What Kennedy then proposed echoed from the years of the Harding and Coolidge administrations. He proposed cutting taxes on the wealthy in order to stimulate the economy and put people back to work:

> This nation's economy can and must do even better than it has done in the last five years. Our choice, therefore, boils down to one of: doing nothing, and thereby risking a widening gap between our actual and potential growth in output, profits, and employment — or taking action, at the federal level, to raise our entire economy to a new and higher level of business activity….

The final and best means of strengthening demand among consumers and business is to reduce the burden on private income and the deterrents to private initiative which are imposed by our present tax system — and this administration pledged itself last summer to an across-the-board, top-to-bottom cut in personal and corporate income taxes to be enacted and become effective in 1963….

For all these reasons, next year's tax bill should reduce personal as well as corporate income taxes: for those in the lower brackets, who are certain to spend their additional take-home pay, and for those in the middle and upper brackets, who can thereby be encouraged to undertake additional efforts and enabled to invest more capital.

And then Kennedy reiterated the lessons learned from Harding and Coolidge:

> In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now….

And the reason is that only full employment can balance the budget, and tax reduction can pave the way to that employment. The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus.

With the passage of Kennedy's tax-cuts bill in the summer of 1963, the economy was allowed to breathe again without the punishment of high tax rates and began to flourish. By reducing the top bracket from 91 percent to 70 percent, tax revenues climbed from $94 billion in 1961 to $153 billion in 1968. And the rising tide lifted all boats as well. Taxes paid by those making more than $50,000 a year rose by 57 percent from 1963 to 1966, while those in the lowest tax bracket saw their rate drop to 14 percent, leaving them also better off than before.

President Reagan was faced with a similar situation when he won the presidency in 1980. Faced with economic "malaise" — a phrase that Reagan used in his campaign against then-president Jimmy Carter — Reagan moved the top tax bracket from 70 percent down to 28 percent, with similar results. The economy began to revive and, along with it, tax revenues to the government. In 1983, federal income taxes were $326 billion, and they steadily increased each year so that by 1989 they totaled $549 billion, an *increase of 68 percent*.

And the wealthy? Because of the significant reduction in the marginal tax rates, the wealth-generators began to do what they do best: They began to invest in the economy once again, with predictable results. In 1981, the top one percent paid 17.6 percent of all personal income taxes, but by 1988, their share had jumped to 27.5 percent. And those in the bottom half? Their share of income taxes *droppe*d from 7.5 percent in 1981 to 5.7 percent in 1988.

Two highly regarded economists, William Niskanen and Stephen Moore, measured the Reagan economy by comparing its performance to the Ford-Carter years (1974-1981) and to the Bush-Clinton years (1989-1995) and came up with the same conclusion.

On eight of 10 key economic indicators, “The American economy performed better during the Reagan years than during the pre- and post-Reagan years.” Real (after-tax) economic growth was higher, family incomes were higher, and unemployment fell faster.

During his second term, President Clinton signed into law a tax cut bill that slashed the capital gains tax rate by a huge 28 percent with results that were predictable: In 1995, just over $8 billion in venture capital was invested in the economy but by 1998, the first full year of the lower capital gains tax rate, venture capitalists invested $28 billion, more than three times the rate just three years earlier. And in 1999, new capital invested in the economy doubled again. And, also predictably, total federal revenue rose each year after the 1998 tax cuts were passed.

The so-called Bush tax cuts of 2001 and 2003 had the same effect. The economy grew for 52 consecutive months resulting in increases in federal tax revenue of $780 billion, the largest four-year increase in American history. Also predictably, taxpayers in the highest brackets wound up paying more in taxes rather than less, which the *New York Times* called a “surprise windfall.” *The Wall Street Journal* noted that because of the cuts, “President Bush will leave to his successor an economy 19% larger than the one he inherited from President Clinton.”

The economic laws involved are immutable. They are also international. In a remarkable “working paper” published by the rarely free-market-friendly International Monetary Fund (IMF), the question was asked: “Can tax rate cuts increase revenues?” The authors studied the impact on the Russian economy in 2005 when the government introduced a flat income-tax rate of 13 percent, replacing a tiered-rate structure that rose as high as 30 percent. The authors were astonished to find:

> Personal income tax revenues have increased significantly: 46 percent … during the next year. Even more interesting [personal income tax] revenues … continued to increase … during the next year.

An increasing number of American states are pushing down income-tax rates in efforts to grow their states’ economies, taking lessons from history (Harding, Coolidge, Kennedy, Reagan, Bush, Clinton, et al.) and applying them locally. In the preface to the fifth edition of *Rich States, Poor States* published by the American Legislative Exchange Council (ALEC), Mary Fallin, the governor of Oklahoma, wrote:

> While many other states were raising taxes in order to close their budget gaps — and driving out jobs in the process — we cut our income tax. We provided relief to working families and spurred economic growth in the private sector. As a result, we have seen a net increase of almost 30,000 jobs in the last 12 months, and our job growth rate ranks in the top ten among all states. Our unemployment rate continues to be one of the lowest in the country at 6.1 percent. And in 2011, Oklahoma ranked first in the nation for the growth of manufacturing jobs, which grew five times faster than the national average.…

Our state is moving forward with a bold tax reform plan that will represent the most significant tax cut in state history and chart a course towards the *gradual elimination of the state income tax*. It will give Oklahoma one of the lowest overall tax burdens in the entire country, making us a more competitive state for those looking to move jobs here. This is the conservative centerpiece of our pro-jobs agenda that will let working families keep more of their hard-earned money and provide a higher quality of life for all Oklahomans. [Emphasis added.]

After reviewing the economic performance of all 50 states, authors Arthur Laffer (developer of the "Laffer Curve"), Stephen Moore (economist with the *Wall Street Journal*), and Jonathan Williams (director of ALEC) concluded that "the results speak for themselves. The no personal income tax [PIT] states outperform their high tax counterparts across the board in gross state product growth, population growth, job growth, and, perhaps shockingly, even tax receipt growth."

They added:

> When it comes to growing gross state product (GSP), the no PIT states have, on average, outperformed those states with the highest rates by 39.2 percent over the past decade. They have also outperformed the U.S. average by 25.6 percent.

Additionally, not even one state in the high tax rate group performed as well as the average no PIT state.

The profound unfairness of raising taxes on the rich has little to do with how the rich will live. They will live well, regardless, through careful tax planning or simply living off interest on money that could otherwise be invested in the economy.

No, the real impact is on the hundreds, thousands, perhaps even millions of workers who will not have a chance to contribute to their own welfare, and society's, in jobs that don't exist and opportunities that won't arise. It even impacts taxpayers who do have jobs, for they will have to bear the burden of government without the help of that additional capital generating additional revenues in the process of adding to the general welfare.

Additionally, to the extent that the wealthy park their idle funds in tax-exempt securities rather than in a lively and growing economy, to that extent local and state governments seeking to borrow by offering tax-exempt securities will find that interest rates will be higher due to the increased demand, impacting negatively the taxpayers once again.

Like coal in a locomotive's boiler, if that coal is withheld, the steam needed to drive the engine is reduced, slowing down the entire economic train. Put another way, in a capitalist society, if capital is restricted and limited and punished, the economy stalls.

On the other hand, in an enlightened world that operates in accordance with predictable economic principles, there will be not only full employment but an higher standard of living for everyone, even (perhaps even especially) those on the lower rungs of the economic ladder.

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