



THE PORTRAIT OF THE U.S. INCOME TAX

By Arthur B. Laffer Ph.D.

I. Introduction

The Sunday New York Times on May 17, 2026, carried the largest special pleading advertisement ever in the paper's history. The healthcare workers union proposed bipartisan legislation for a yearly six-thousand-dollar tax credit for healthcare professionals as "just a start." Special pleadings for government favors have become the norm. Businesses and labor organizations have found it to be more profitable to lobby government than it is to sell more and make better products in the marketplace. Tax credits as a path for special favors require dysfunctional tax systems.

This paper's primary focus is the income tax and all of its twists and turns corresponding to policy innuendos. But the income tax is by no means the only dysfunctional tax. We have property taxes, sales taxes, social security taxes (officially called "contributions"), excise taxes, tariffs, and so on. While the specifics of each of these tax structures are different, the principles are the same.

We tax speeders on roadways to get them to stop speeding, we tax smokers to get them to stop smoking, and we fine (tax) lawbreakers to get them to stop breaking laws. Why, then, do we tax people's incomes, have employment taxes, or have a tax on the profits of companies which make terrific products at low cost?

Of course, we don't tax incomes to get people to stop earning incomes, or employment to reduce employment, or profits to get companies to stop making wonderful products at low cost. We say we tax those items to raise the requisite revenues to fund government. But don't think for a moment that because our reasons for taxing are different, the same damaging effects of taxes on income, employment, and profits won't be felt. Income taxes make earning income less attractive and reduce incomes. Employment taxes reduce employment. Profits taxes reduce the quality and quantity of goods and services. Period! We're talking here about facts, not how you feel. All taxes change incentives, and when incentives are changed, people respond. Economics is all about incentives, pure and simple. If you tax something, there will be less of it.

There are two broad categories of incentives: positive and negative. By way of illustration, if you feed a dog, you know where that dog will be at feeding time. In this case, feeding is a positive incentive. If, on the other hand, you beat a dog, which is a negative incentive, you know where the dog won't be. It won't be anywhere near you, but the dog will make sure that you won't know where the dog will be.

Positive incentives tell people what to do, while negative incentives tell people what not to do. All taxes, including income taxes, are negative incentives telling people what not to do. Do not report taxable income. The income tax does not, by itself, have any specific preferences as to how not to report taxable income. As with our dog example, it makes no sense to comingle positive and negative incentives. Splicing random beatings into a dog feeding program is absurd. And yet, we do mix positive incentives, such as credits, deductions, write-offs, and preferences inside a comprehensive tax program with no second thought. We even call them tax expenditures.

There are three basic categories of general revenue taxes each based on a separate concept of the tax base:

- a.) Income, net sales, and value-added taxes. Here, in each case, the tax base is roughly total GDP and reflects a flow over a given period of time.
- b.) Turnover taxes, such as gross sales taxes, revenue taxes, and tariffs. Here, the tax base is total transactions and also is a flow over a given period.
- c.) Wealth taxes, such as property taxes, asset taxes, and overall wealth itself. In this case, the tax base is the aggregate value of the stock of all assets at a given moment in time.

Tax rates on these three tax bases are not directly comparable. As a rule of thumb, a 1% tax rate on wealth is roughly comparable to a 4% tax rate on transactions and a 12% tax rate on incomes. It is risky to rely on more than one tax as a primary revenue source.

The Income Tax

This white paper exposes the essential economic traits of the U.S. progressive income tax. Progressive income taxes, where higher and higher tax rates apply to higher and higher levels of reported income, have an outsized impact on an economy. Even when they bring in miniscule amounts of tax revenues, progressive income taxes can still have a crippling effect. At 100% tax rates, there will be very little tax revenue, but the economy will be devastated.

Prior to 1913, a U.S. income tax was believed to be unconstitutional. After a long, tedious process culminating in early 1913, the 16th amendment to the U.S. Constitution was passed, which explicitly permitted a progressive income tax. Within six months of the amendment's adoption, the U.S. Congress passed a bill which President Woodrow Wilson signed, giving birth to America's first modern income tax.¹

The reasons given by advocates and opponents of an income tax back then, as they are now, are i) an income tax raises a prodigious amount of tax revenues, ii) a progressive income tax taxes people based on their ability to pay, and iii) a federal progressive income tax reduces income inequality. What wasn't contemplated was i) the effect such a tax structure would have on economic growth and poverty and ii) the lengths to which high income earners who were faced with those higher tax rates would go to in order to circumvent high tax rates. As you will see, changes in the U.S. tax code elicit massive changes in behavior with enormous unintended consequences. Some people never learn.

Mitt Romney

Mitt Romney, the latest member of a large group of wealthy individuals, in a Wall Street Journal editorial² proposed increasing the top marginal income tax rate on people like himself to solve what he described as the "inevitable calamity" of mounting debt. In this editorial, he assumed higher tax rates on the rich would simultaneously raise tax revenues and would have little effect on the nation's prosperity. To him, the answer is obvious. But as you'll soon see, that ain't so!

But even if it were true that higher tax rates would raise additional revenues, that by itself wouldn't be sufficient to justify higher tax rates. Martin Feldstein, when asked in 2010 what the Laffer rate was, answered, "Why look for the rate that maximizes revenue...as the tax rate rises, the "deadweight loss" (real loss to the economy) rises so as the rate gets close to maximizing revenue, the loss to the economy exceeds the gain in revenue...I dislike budget deficits as much as anyone else. But would I really want to give up \$1 billion of GDP in order to reduce the deficit by \$100 million? No. National income is a goal in itself. That is what drives consumption and our standard of living".³ The 2010 Professor is 100% correct. The best tax rate is well below the maximum revenue raising tax rate.

Former Utah Senator Romney does not seem to appreciate or even acknowledge the adverse effects top tax rate increases have on everyone else. If it makes him feel good, Senator Romney should know that he is allowed to contribute more than his taxes owed to the IRS. Be our guest. But please, don't force everyone else to do the same.⁴

We've all learned time and again that high tax rates curtail productive work and investment. An economy can't be taxed into prosperity. Among the many policies that damage the economy, progressive income taxes are among the worst because they are progressive: Taxing people with higher incomes at higher tax rates is counterproductive. A progressive income tax penalizes all income earners, but it disincentivizes the most productive of all producers because they are the most productive.

From the very early years of the income tax, its deleterious effects on the economy were apparent. Even though top tax rates were low and few people were even required to file tax returns, the economy still underperformed. Increases in top tax rates and increases in required filings are inevitably associated with lower wages, higher unemployment, and underperformance. From 1913, when the top tax rate was 7% and only 358 thousand people were required to file income tax returns to 1918,

¹ From 1861 through 1870, the U.S. adopted a temporary flat income tax to fund the war effort and later to pay off war debts.

² *Mitt Romney: My Country Before My Tax Bill*, WSJ Opinion, 19 Jan 2026.

³ Matthews, Dylan. "Where does the Laffer Curve Bend?", *The Washington Post*, 9 Aug 2010. http://voices.washingtonpost.com/ezra-klein/2010/08/where_does_the_laffer_curve_be.html

⁴ Final Line on tax filing form

when the top tax rate peaked at 77% and required filings had risen to 4.4 million, the standard of living (total U.S. output less defense spending) was abysmal.

High top tax rates were the focus of the presidential race in 1920. The Democrats wanted to keep top tax rates at over 70% to “pay off” the debt, while Republicans wanted to drastically lower tax rates, citing a “return to normalcy.” The Republicans won by the largest percentage ever. Anyone who tells you that voters like high tax rates is ignoring the evidence. Politicians are the ones who like high tax rates, not taxpayers. Tax favors handed out by politicians require high tax rates to be valuable. In the immortal words of Louisiana Senator Russell Long, “Don’t tax you, don’t tax me, tax the guy behind the tree.”

After the elections of 1920, high tax rates were phased out over a number of years to much lower tax rates which created powerful incentives for income earners to defer realizing taxable income. Imagine what you would do if you knew tax rates next year would be a lot lower than they are this year. First, you would defer as much taxable income as you could from the high tax year to the low tax year. Second, you would accelerate as many deductions as you could from the low tax year into the high tax year.

It only makes common sense that tax deductions are more valuable when tax rates are high, and incomes are more valuable when tax rates are low. The value of a deduction is directly proportional to the income tax rate. These tax incentives to defer income and accelerate deductions led to a serious post-World War I economic collapse. But once the top tax rate fell to 25% and the number of tax filers declined, the economy boomed. The federal budget, if you can believe it, was in surplus for eleven straight years and tax receipts from the rich, no matter how measured, soared. This period was, after all, called the roaring 20’s.

Tax the Rich: The Harding/ Coolidge Tax Cuts

John Lennon’s song *Imagine* is the most eloquent Clarion Call of a Fabian socialist. He should have been on the faculty of MIT.

*imagine no possessions
I wonder if you can
No need for Hunger
A brotherhood of man
Imagine all the people
Sharing all the world*

Perhaps most illustrative of the power of the Harding/Coolidge tax cuts of the 1920s were the increases in GDP, the fall in unemployment, and the improvement in the average American’s quality of life.

In the 1920 tax return form 1040 itself, marginal tax rates rose progressively from 8%, 11%, 19%, 56%, and peaked at 73% for the highest income earners. By contrast, in the 1929 tax return, for those same income tax brackets, the tax rates were 3%, 5%, 12%, 24%, and 25%. That’s one helluva tax cut (see Table 1). Guess what happened to the respective shares of taxes paid by each income tax cohort. You’re correct if you said the share of taxes paid rose directly in proportion to the income tax bracket (Table 1). Tax rate cuts on the highest income earners led to a surge in tax revenues. Think of it. The highest tax rate was reduced to a third of its previous level and the richest share of total taxes more than doubled.

Table 1
**Percentage Share of Total Income Taxes Paid
 and Statutory Marginal Tax Rates By Income Class for Select Years**

Income Class	1920	1925	1929	1920-1929 Change in Tax Share
Under \$5,000 Tax Rate	8%	3%	3%	↓
Tax Share	15.4%	1.9%	0.5%	↓
\$5,000-\$10,000 Tax Rate	11%	5%	5%	↓
Tax Share	9.1%	2.6%	1.0%	↓
\$10,000-\$25,000 Tax Rate	19%	12%	12%	↓
Tax Share	16.0%	10.1%	6.0%	↓
\$25,000-\$100,000 Tax Rate	56%	24%	24%	↓
Tax Share	29.6%	36.6%	27.4%	↓
Over \$100,000 Tax Rate	73%	25%	25%	↑
Tax Share	29.9%	48.8%	65.2%	↑

Source: IRS

In regard to the 1920s, historian Benjamin Rader concluded, "Despite sharply reduced tax rates for upper income groups...the wealthy paid a larger share of the federal tax burden at the end of the decade than at the beginning."⁵ The evidence strongly indicates that the tax cuts of the 1920s did indeed raise revenue among those most affected by the rate reductions.

But those income classes with lower tax rates were not left out in the cold. The Harding/Coolidge tax-rate cuts resulted in reduced tax rates on lower income brackets. Internal Revenue Service data show that the dramatic tax cuts of the 1920s resulted in an increase in the share of total income taxes paid by those making more than \$100,000 per year from 29.9% in 1920 to 65.2% in 1929. Keep in mind the significance of this increase. The 1920s was a decade of falling prices and therefore a \$100,000 threshold in 1929 represented a higher real income threshold than \$100,000 did in 1920. The consumer price index fell a combined 14.5% from 1920 to 1929. In this case, the effects of bracket creep that existed prior to the federal income tax brackets being indexed for inflation (in 1985) worked in the opposite direction.

*Though the marginal tax rates were cut much more for the highest income taxpayers, the effective burden of taxation shifted away from the lower-income taxpayers toward the higher-income taxpayers. The resulting decline in tax avoidance, in conjunction with economic growth, led to some increase in personal income tax receipts despite the huge tax cuts from 1921 through 1926. Thus, the tax rate cuts worked much as Mellon and other early "supply-side" supporters had argued that they would.*⁶

—Smiley and Keehn, 1995

Anticipation of Tax Cuts in The Reagan Era

Over the years we've learned time and time again that people anticipate legislated changes in taxes over horizons near and far. They shift taxable income out of a high-tax year to a lower-tax year or out of a higher-tax form of income into a lower-tax form of income. This income shifting is exactly what happened when Presidents Harding, Kennedy, and Reagan phased in tax rate reductions and also what happened in the opposite direction when Presidents Wilson, Hoover, Roosevelt, and Obama phased in tax increases. Just look at Figure A, which plots quarterly real GDP growth in the five quarters preceding the full Reagan tax cut and the eight quarters following the tax cut. What could be clearer?

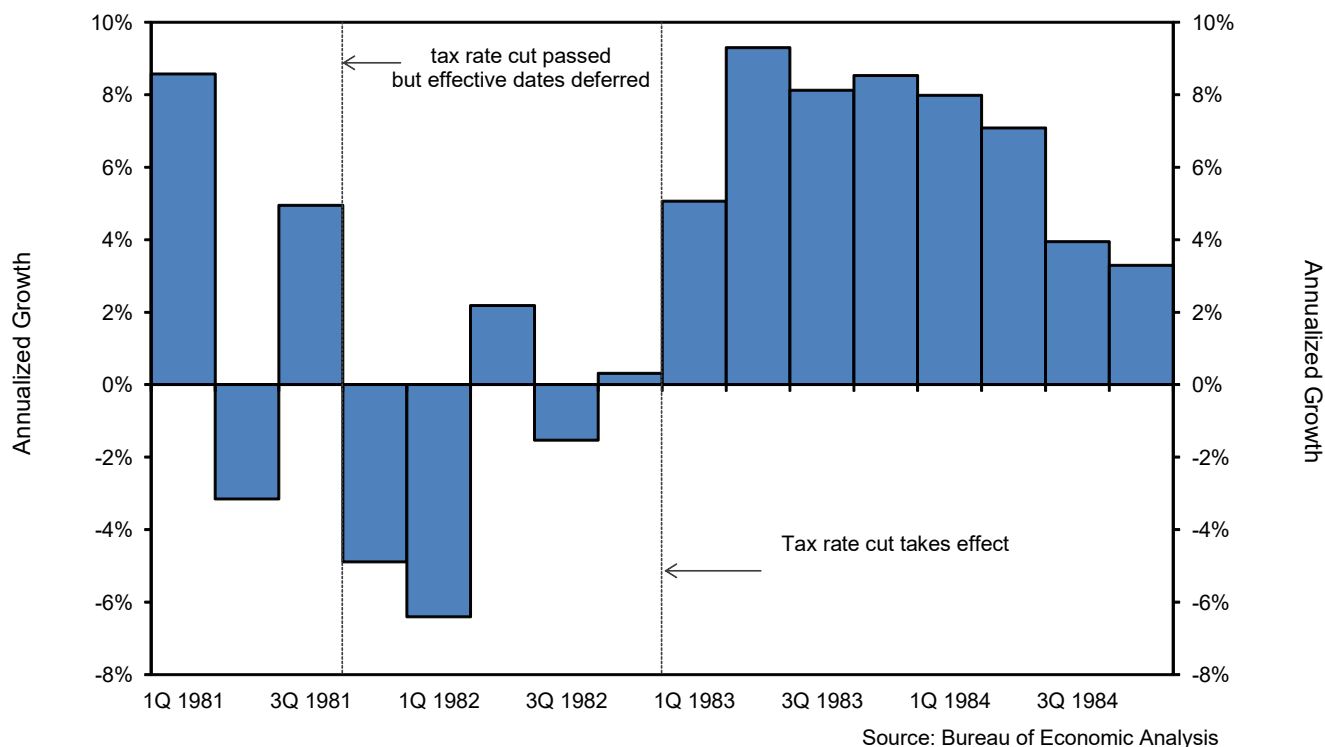
President Reagan's Economic Recovery Tax Act (ERTA), enacted in August 1981, cut tax rates by 5% on October 1st, 1981, 10% on July 1st, 1982, and a final 10% on July 1st, 1983. This description is misleading because there is no such thing as a mid-year tax rate cut. All income reported in a calendar year is taxed on the same tax schedule. In fact, because tax rates were legislated to be cut in October, for filing purposes, tax rates for the whole year of 1981 were cut by 1.25% (¼ of the 5%), which started retroactively on January 1st, 1981. Then on January 1st, 1982, actual tax rates fell by a total of 10% (the full 5% of 1981 plus ½ of 1982's 10%) and finally fell by 20% on January 1st, 1983. The U.S. boom began literally on January 1st, 1983 (Figure A). It's amazing how tax cuts don't work until they take effect. But once they do take effect, the results can be explosive (Figure A). I know of no evidence showing the timing of responses to tax rate changes better than those of the Reagan years.

⁵ Benjamin G. Rader, "Federal Taxation in the 1920s: A Re-examination," *The Historian*, May 1971.

⁶ Gene Smiley and Richard H. Keehn, "Federal Personal Income Tax Policy in the 1920s," *The Journal of Economic History*, June 1995.

Think of it, in only eighteen months, or six quarters, or one-and-a-half years, from Jan. 1, 1983 through June 30, 1984, real GDP grew by 12%, or at an annual average rate of 8%. Wow!

Figure A
Real GDP Growth
(quarterly, qtr/qtr annualized, 1981-1984)



A lot of people thought the deep recession of 1981-1982 was a by-product of tight money adopted by Federal Reserve Chairman Paul Volcker to wring inflation out of the U.S. economy. But that view is silly on its face. How on Earth could re-establishing sound money and stable prices cause a recession? It couldn't. What caused the deep recession of 1981 and 1982 was simply the phase-in of President Reagan's tax cuts. Who would shop at a store the week before that store has its pre-announced discount sale? No one! This phased in tax cut policy led to similar deep recessions after World War I and in the early 1960s.

To help convince you that this explanation is not just an ex post facto rationalization of the circumstances, here's what I said in a December 1981 *Barron's* interview as to what I thought would happen⁷:

Q. *Well, are you disappointed, so far, with Reaganomics?*

A. I am not surprised about what's happening with the current administration. But I'm disappointed, frankly, that Stockman had enough influence to convince the President to postpone the tax cuts.

Q. *Why?*

A. Let me answer this way: Suppose you have to go back to school and not earn income in one of the next two years. But you get to choose which year. Which year do you go back? This year, when tax rates are high, or next year, when tax rates are low? Which is the year you choose not to earn your income? That is what we are seeing happen.

⁷ "No Shrinking Supply-Sider: Economist Arthur Laffer Keeps the Faith," *Barron's*, December 21, 1981.

People were deferring their income so that they could take advantage of lower tax rates in the future, and they were accelerating expenses so that they could deduct them against the high tax rates ahead of the tax cuts. That was what I was saying then. The interview continues:

Q. *What is your economic forecast, Arthur, for next year?*

A. 1981, obviously, has been a bad year because they postponed the tax cuts, and 1982 doesn't look great.

Q. *You said before, Arthur, that you think the timing of Reagan's tax cuts is off. Are you satisfied, though, once the full impact of the program is felt...?*

A. Once we are in '83 and '84, we are going to be in a great economy.

Q. *You sound pretty definite about that.*

A. Oh, yeah, there is no question of that in my mind. I couldn't be more certain of a proposition than I am of that, given the uncertainty of my profession. Everything I look at, the fastest-growing economies in the world—from the Ivory Coast to Hong Kong to whatever—all have low tax rates. High taxes reduce the incentive to profit, and you just don't expand really rapidly through government. Especially not through redistribution policies.

And so, the story continues. With high top tax rates, a progressive income tax in general wreaks havoc on the U.S. economy.⁸

Tax Sheltering

Even more shocking than the economic damage done by high tax rates on the rich is the near certainty that when high marginal tax rates on the rich are in effect, income sheltering strategies and under-reporting surge. It's just plain common sense that if the top tax rate is 10%, you'll spend 10% percent of your time trying to reduce your taxes and 90% trying to earn more. If, however, the top tax rate is 90%, you'll spend 90% of your time trying to reduce taxes and only 10% of your time trying to earn more. High top tax rates on the highest income earners incentivize high income earners to shelter their high incomes. It's a lot easier for the well-to-do to figure out tax shelters with their advisors than it is to earn more income when faced with stiff competition and high tax rates.

U.S. tax codes are inordinately complex. And people who are well off have both the ways and the means to reconfigure their overall tax filings. They hire lawyers, accountants, deferred income specialists, and favor grabbers to change the volume, timing, location, and composition of their reported incomes for tax purposes. And just for the record, well-to-do income earners are very successful at sheltering their incomes. To quote ProPublica, "ProPublica has obtained a vast cache of IRS information showing how billionaires like Jeff Bezos, Elon Musk, and Warren Buffett pay little in income tax compared to their massive wealth—sometimes, even nothing."⁹

In our own work based on Warren Buffett's voluntary disclosures to The New York Times, we found that his tax payment in 2010 was 0.06% of his actual Haig-Simon income¹⁰. Even if they're not personally knowledgeable, people of means always surround themselves with very smart employees who are knowledgeable and incentivized. And that's the truth! The IRS doesn't stand a chance.

President Franklin Delano Roosevelt's Treasury Secretary Henry Morgenthau recounted the problem best, noting that high tax rates on the rich called forth government agents to collect the revenue against the recalcitrant high earners. After a short while, a portion of the best of these agents would quit government, and based on their experience gained there, make ten times as much showing the rich how to avoid the tax rates.¹¹

⁸ Laffer, Arthur B. Domitrovic, Brian. Sinquefield, Jeanne. "Taxes Have Consequences: An Income Tax History of The United States" *Post Hill Press*, 2022.

⁹ Eisinger, Jesse. Ernsthauten, Jeff. Kiel, Paul. "The Secret IRS Files: Trove of Never-Before Seen Records Reveal How The Wealthiest Avoid Income Tax" *ProPublica*, Accessed 2/17/2026.

¹⁰ Laffer, Arthur B. "Class Warfare and the Buffett Rule", *WSJ Opinion*, 11 Jan, 2012.

¹¹ Laffer, Arthur B. Domitrovic, Brian. Sinquefield, Jeanne. "Taxes Have Consequences: An Income Tax History of The United States" *Post Hill Press*, pg 45, 2022.

But even when the ultra-high income earners like Mitt Romney express feelings of guilt, they make flimsy excuses to justify why they still avoid paying taxes. In 2007 Rebecca (Becky) Quick of CNBC asked Buffet why he shelters his money through tax-free strategies, rather than writing big checks to Uncle Sam. Here was his answer: "Well, that's a choice and it's an option. If I had to give it to a single individual, or make some young Buffett a multibillionaire, or give it to the government, I'd absolutely give it to the government. I think that on balance the Gates foundation, my daughter's foundation, my two sons' foundations will do a better job with lower administrative costs and better selection of beneficiaries than the government".¹² In other words, Warren Buffet thinks he can do a better job with his money than give it to the government. I guess he's really not so different from the rest of us after all.

Moreover, the rest of us act just the same way. We all shelter or curtail our reportable income when tax rates affecting us get too high. An example Paul Craig Roberts drew on in his classic takedown of the Keynesian consensus, "The Breakdown of the Keynesian Model," of 1978 was that of the do-it-yourselfers. As Roberts wrote:

"The marginal tax rates that many blue-collar workers already face are high enough to discourage them from earning additional taxable income. Take the case of a carpenter facing only a 25-percent marginal tax rate. For every additional \$100 he earns before income tax, he gets to keep \$75. Suppose that his house needs painting and that he can hire a painter for \$80 a day and hire himself out for \$100 a day. However, since his after-tax earnings are only \$75, he saves \$5 by painting his own house, so it pays him to choose not to earn the additional \$100. In this case, the tax base shrinks by \$180—of which \$100 is the foregone earnings of the carpenter, and \$80 is the lost earnings of the painter who is not hired. (Also, the productive efficiency associated with the division of labor vanishes.)

"Suppose, instead, that the marginal tax rate on additional earnings by the carpenter were reduced to 15 percent. In this case, his after-tax earnings would be \$85, and it would pay him to hire the painter. The reduction in the marginal tax rate would thus expand the tax base upon which revenues are collected by \$180."¹³

A similar effect happens when high tax rates force barter exchanges. A tale from high-tax Britain of the 1970s had a doctor taking a case of scotch for removing the appendix of a wealthy businessman. At a 98 percent tax rate (the UK actually sported so high a top tax rate), a high-earning doctor would have to gross 50,000 pounds in earnings to net 1,000 in pay for the procedure, while the businessman would have to gross 2,500,000 pounds in pay to net the 50,000 in order to pay his doctor friend so that the doctor would net 1,000 pounds. At 98 percent tax rates on either end, 2.5 million pounds became one thousand pounds. The two dispensed with the idea of cash and traded the scotch for the removal, declared nothing, and called it square. High progressive tax rates discourage the earning and declaring of tax-reportable income—up and down the income scale.

II. The Logic of Supply-Side Economics

If you aren't a professional economist or if you haven't studied economics for the last 30 years, you will probably remember Paul Samuelson's talking parrot describing the totality of what economics is as "supply and demand." What follows should be called supply and demand economics but thanks to Herb Stein, the word demand has been dropped from the title, but not the concept of demand. It's still here in equal force with supply.

In any normal market, the demand for a product can be represented as a relationship between the quantity demanded and the price demanders are willing to pay. In terms of graphs, if the horizontal axis is Quantity and the vertical axis is Price, then the line relating quantity demanded and price paid—the "demand curve"—will go from upper left to lower right (see Figure B). This demand curve (in blue) shows how, as the price rises, the less quantity demanders will demand, and as the price falls, the more demanders are willing to purchase.

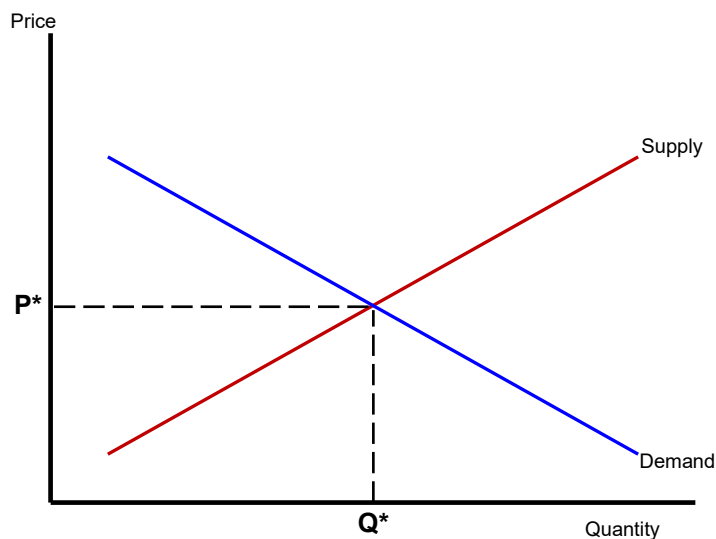
Then there's the supply curve (also Figure B), which relates the quantity of a product suppliers are willing to supply to price. The lower the price, the less supplied, and the higher the price, the more supplied. The supply curve in Figure B starts in the lower left and moves to the upper right. Note that this is the case when there is no interference or inefficiency in the market.

¹² "Warren Buffett's Tax Dodge," WSJ, available at <https://www.wsj.com/articles/SB10001424053111903918104576504650932556900>

¹³ Paul Craig Roberts, "The Breakdown of the Keynesian Model," *The Public Interest* 52 (Summer 1978), 23.

The point where the supply curve and demand curve intersect shows the *equilibrium* market-clearing price, P^* , i.e. the price where the quantity suppliers are willing to supply is equal to the quantity demanders are willing to buy, Q^* .

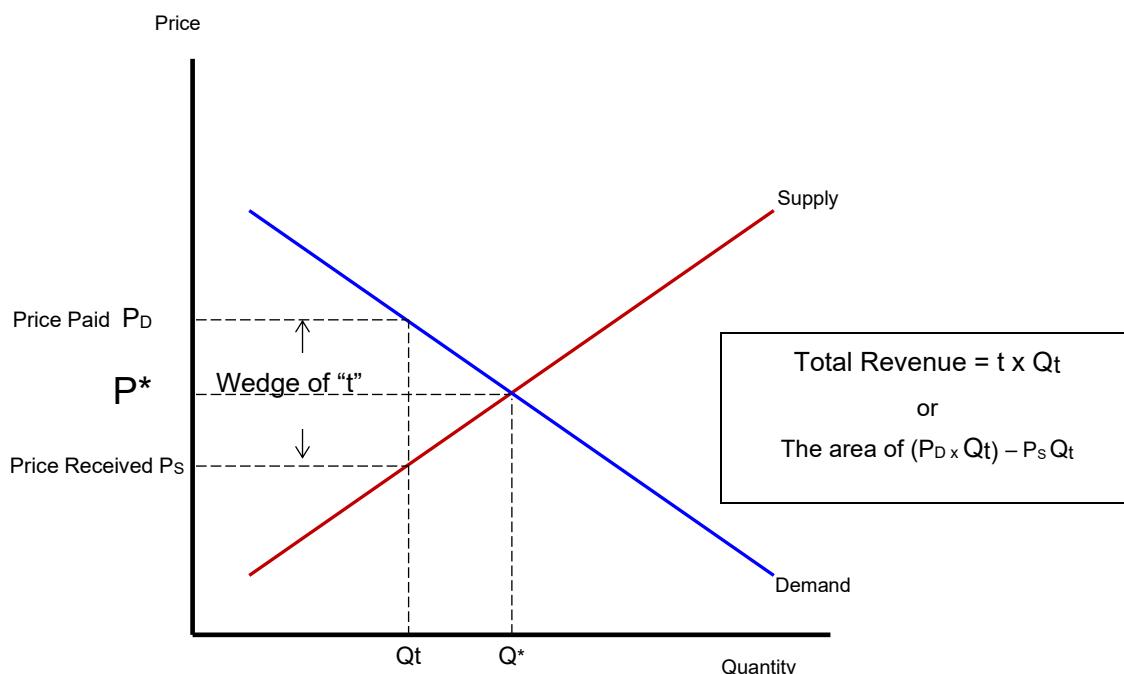
Figure B
Demand and Supply Curves



In Figure B, the demand curve, supply curve, prices, and quantities are abstract concepts, but they make clear how markets actually function. A price, of course, is nothing more than the ratio of two commodities in exchange. There's always a "quid" for the "pro quo." What matters is how behavior (i.e., the shapes of demand and supply curves) responds to changes in incentives (i.e., the price ratio) in determining outcomes (i.e., quantities).

By way of example, if government imposes a tax " t " on the transaction as shown in Figure C, this will drive a wedge between the demand curve and the supply curve as shown in Figure C. There will now be two prices: price paid by demanders " P_D ", which is higher than P^* , and price received by suppliers " P_S ", which is lower than P^* , where the difference between P_D and P_S is the tax " t ". There will also be a new quantity " Q_t " at the point where " P_S " + " t " equals " P_D ", which is lower than Q^* . We could also show tax revenues as " t " x " Q_t " etc. This is our framework.

Figure C
The Imposition of a Tax on Demand and Supply



The obvious take-away from the framework of Figures B and C is that the imposition of a tax will reduce the quantity of the product supplied and demanded by driving a wedge between the after-tax prices suppliers receive and the pre-tax prices demanders pay.

Economics is all about incentives! Incentives are malleable and government actions can dramatically impact those incentives. In the realm of macroeconomics, government tax policies (negative incentives) make activities less attractive, while subsidies (positive incentives) make activities more attractive. There are a number of secondary consequences as well. In our framework, government redistributes resources; it does not create resources.

III. Here's The Bottom Line: The Facts

Tax Revenues from the Rich

Bringing our explanation of basic economics from an abstract supply and demand back to the political reality of government policy, the question that needs to be answered is straightforward and clear: what happens to tax revenues from the rich when the top tax rate is raised or lowered? Figure D plots average real tax revenues per top 1% earner versus the top tax rate by year from 1913 through 2022. Please look at this graph carefully. The answer won't change.

Figure D
Average Annual Real Tax Revenue per earner in the Top 1% Detrended vs. Top Tax Rate
 (annual, 1913-2022, detrended using a 1.2% trend)

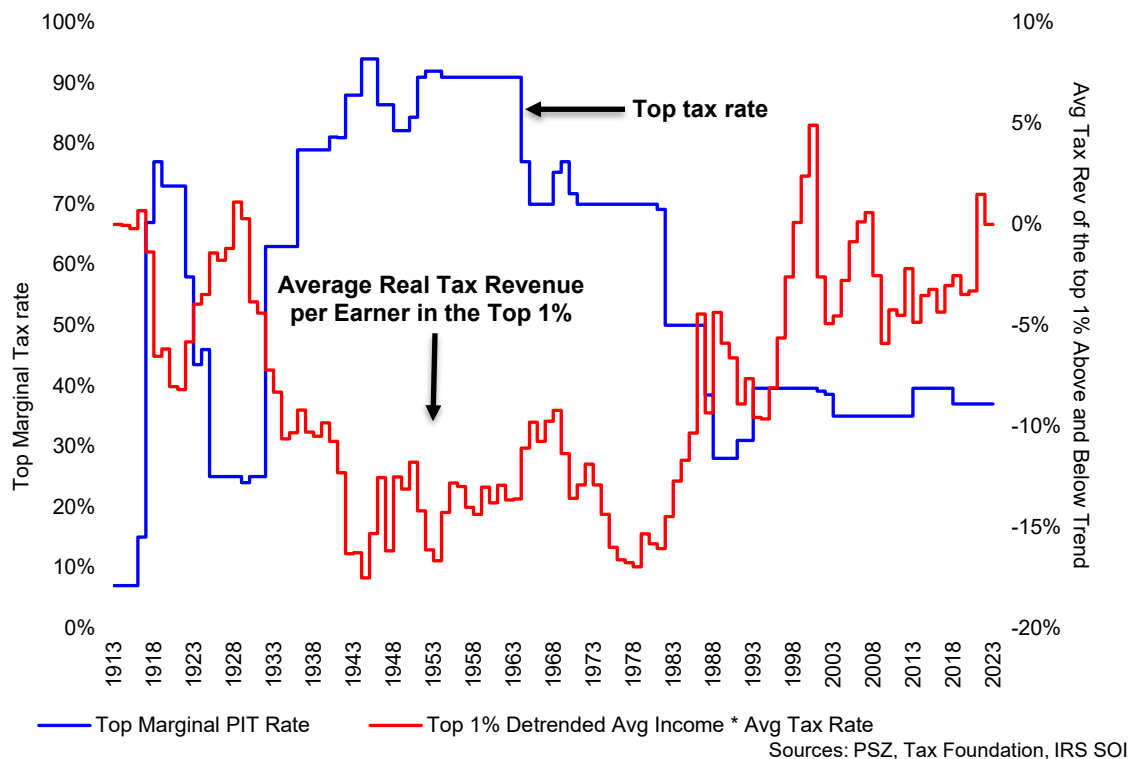


Figure D shows that when one simple policy variable—top tax rates on the rich—rises, average tax revenues collected from the rich fall. When top tax rates on the rich are high, average real tax revenues are low, and when top tax rates fall, average tax revenues rise. Lastly, when top tax rates are low, average tax revenues are high and rising. It should be noted here that as our measure of tax becomes more and more granular, including such things as tax rates in the lower tax brackets, deductions, etc., the correlation becomes better and better.¹⁴ The significance of Figure D is hard to overstate.

Tax sheltering in eras of high tax rates becomes extreme beyond almost all manner of description. Circa 1960, when top tax rates ran up to 91 percent (and rates at 50 percent and up hit the marginal income of a large portion of the extended business and professional class), legal tax avoidance rose to the level of a national pastime. Executive lunches lasted two and a half hours and the menus were exercises in haute cuisine—the lavish expense deductible from corporate profits income taxed at 52 percent and unreportable to the high-earning individual. “Eating your way to solvency” was an aphorism at this time—one made sure to eat out, on the company dime, so that the firm could deduct the expense and the recipient did not have to report it. This was the tip of an immense iceberg whereby particularly the income of the rich morphed into non-reportable compensation. “Working” vacations, club dues, school tuitions, deferred compensation, lump sum pensions—the universe of high-end tax-avoidance devices was unending when tax rates were high. Crucially, the value of a tax deduction, or a provision rendering compensation as non-reportable, rises with the marginal tax rate. When the marginal tax rate falls, the value of tax avoidance devices declines.

Because a significant portion of tax sheltering occurs prior to income reporting requirements, Figure D and the data underlying Figure D materially understate the effects of tax rate changes on tax revenues of the rich. Many of those who are truly high-income earners and who should be in the top 1% of income reporters so control their reported incomes that they don’t even report enough income to be in the top 1%. Remember the case of Mrs. Dodge in 1953. She reported no income whatsoever from her \$56 million estate in state and municipal bonds.

Based upon the work of Saez, Piketty, and others, as well as our own research, Warren Buffett—the world’s richest man as of 2015—would, based upon his reported income, be downgraded substantially, from the highest income earner in the country to

¹⁴ Moore, Rachel. Pecoraro, Brandon. Splinter, David. “Is the Laffer Curve Flat?”, Joint Economic Committee on Taxation, 6 Feb. 2026.

somewhere around the 5,000th highest income earner in the U.S. Ranking 5,000th in America grossly understates the effect of the sheltering done by Warren Buffett. The 4,999 individuals reporting higher incomes also shelter their income, but few do so as effectively as Buffett.

If raising top tax rates on the rich leads to less tax revenues from the rich, as Figure D shows, what's the point of raising these top tax rates? Raising tax rates on anyone without yielding more tax revenues is counterproductive. Even if you want to tax the rich to help the poor, at a bare minimum you need to collect more money from the rich to give to the poor. And that isn't what happens.

What we've just discussed was limited to direct tax revenues collected from the rich, but there's a whole lot more tax revenue lost as a result of high-top tax rates on the rich. When tax rates are high, the rich will hire less people, reducing their employees' incomes and thus the taxes they pay—including income, payroll, property, and sales taxes. With lower incomes and less reported profits, corporate taxes will fall, as will taxes on capital gains and death taxes. State and local tax revenues will also fall from state sales, income, property, and all the other taxes collected at that level of government. These secondary, tertiary, and quaternary effects can be large and only make our case more convincing.

Similarly, federal tax-rate cuts on the highest earners lead to revenue increases across the domains of state and local tax systems. The 1982 study by Laffer et al. of the John F. Kennedy tax cut of 1964 showed that state and local income tax revenue increased well beyond what it would have without the federal tax-rate cut. The effect on sales and property taxes, at the state and local level, was necessarily positive as well. Revenue from all non-federal tax domains goes up when federal tax-rate cuts prompt national economic growth. These revenue increases at the state and local level occur even when these subsidiary governments do not change their tax structures or tax rates at all. A federal tax rate cut leads to greater revenues from the same state and local tax systems.¹⁵

Going back to Figure D, it is super important to recognize that the chart only records the direct tax revenue consequences of changes in the top tax rate. If all tax revenue consequences were included, those numbers would be far greater and more pronounced than shown in Figure D.

Income Inequality and the Top Tax Rate

Pursuit of greater income equality can only make sense if poverty is reduced as a consequence. Hurting the rich without benefiting the poor may make the distribution of income less unequal, but it's bad policy. The true goal of the quest for greater equality has to be to benefit the poor. And, following up on our last section, it's hard to make the poor better off by raising the top tax rates if tax revenues from the rich actually fall when top tax rates are raised (see Figure D).

Incentive Rates Versus Tax Rates

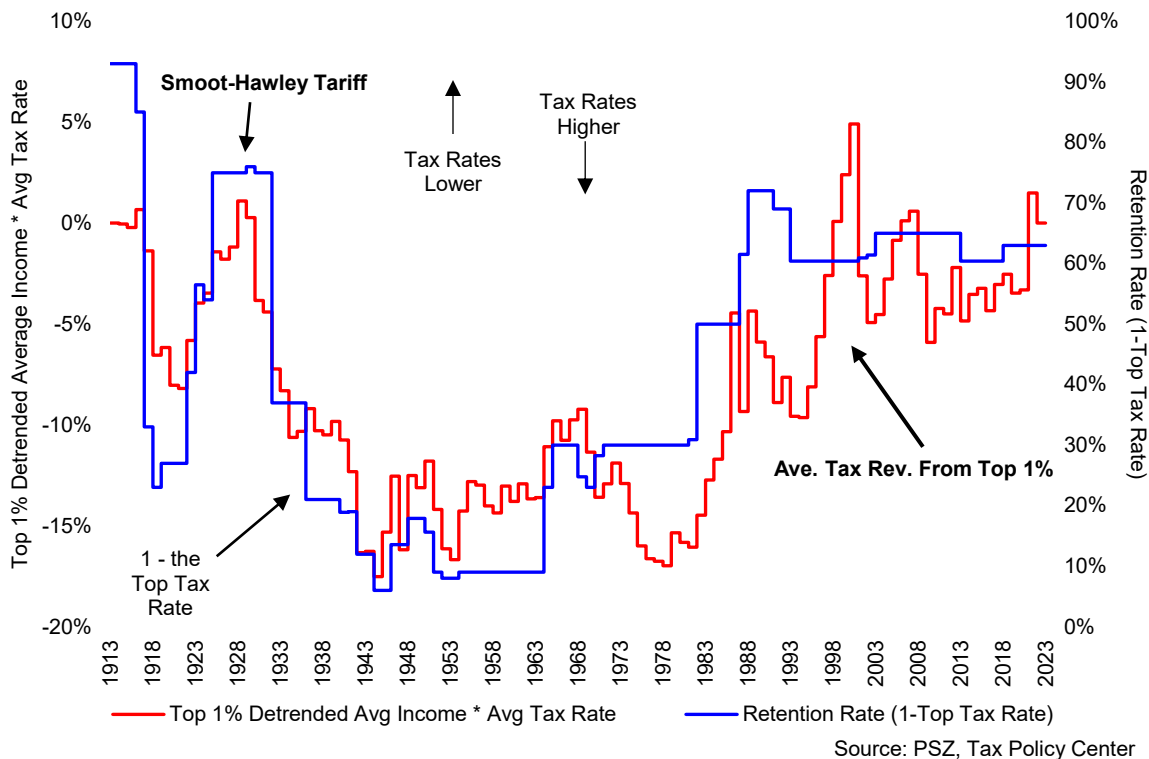
Visually, another way to display the same data as shown in Figure D on page 10 is to focus our attention on the after-tax marginal incentive rate on income from the rich—one minus the top tax rate—rather than on the top tax rate itself. People, even rich people, do not work or invest to pay taxes. They work and invest based on what they are allowed to keep, i.e. the after-tax return. In Figure E, the relationship shown is between the after-tax return—one minus the highest tax rate—and average real tax revenues of the top 1%. The data used in Figure D and Figure E are identical but how they are displayed makes all the difference in the world. Figure E reflects taxpayer behavior far better than does Figure D. Reducing the top tax rate from say, 99% to 98%, is only a 1% reduction of that tax rate but is a 100% increase in the incentive rate from 1% to 2%.

The reason for cutting the highest tax rate is simple. Cutting the top tax rate has an enormously-magnified effect on behavior relative to a cut on lower tax rates. Incentives matter. Just look at Figure E and you'll see exactly what we mean.

In Figure E, we substitute the incentive rate—one minus the top tax rate—for the top tax rate. The visual is shocking.

¹⁵ Victor A. Canto, Douglas H. Joines, Arthur B. Laffer, *Foundations of Supply-Side Economics: Theory and Evidence* (New York: Academic Press, 1983), 91.

Figure E
Average Real Tax Revenues per Top 1% Earner Detrended vs. Retention Rate of Top Tax Rate
 (annual, 1913 through 2022)



Even to the untrained eye, it is obvious that incentive rates and average real tax revenues from the rich move together closely. Make something more attractive and people will do more of it. Make something less attractive and they will do less of it. The correlation shown in Figure E is especially impressive when you realize that we are only looking at one variable in the entire tax code—the top tax rate paid by the rich. Figure E doesn't even consider corporate tax rates, death taxes, payroll taxes, state and local tax, deductions, lower echelon tax rates, etc.

Coming full circle, Figure E is arguably the single most important fact surrounding the progressive income tax schedule, featuring the actual taxes paid by the nation's highest income earners. It took some work to get even the conservative lions of the field of economics to come around and face these facts. Reagan's Council of Economic Advisers chair, Martin Feldstein, five years into the Reagan tax cuts in 1986 said, "The height of supply-side hyperbole was the 'Laffer curve' proposition that the tax cut would actually increase tax revenue." Nine years later, studying the evidence of the next and most profound Reagan tax cut, of November 1986 (that took the top tax rate down from 50 to 28 percent), Feldstein saw no hyperbole in saying tax-rate cuts at the top bring in the revenue. Of the Clinton tax increase of 1993 (taking the top tax rate from 31 to almost 40 percent), he wrote after a detailed econometric analysis, "It follows that these tax rates could be reduced to their pre-1993 levels with little or no revenue loss." Feldstein stuck with conclusions of this stripe for the rest of his career. In 2011, he wrote, "a tax reform that includes lower rates can change incentives in a way that grows the tax base and produces extra revenue."¹⁶

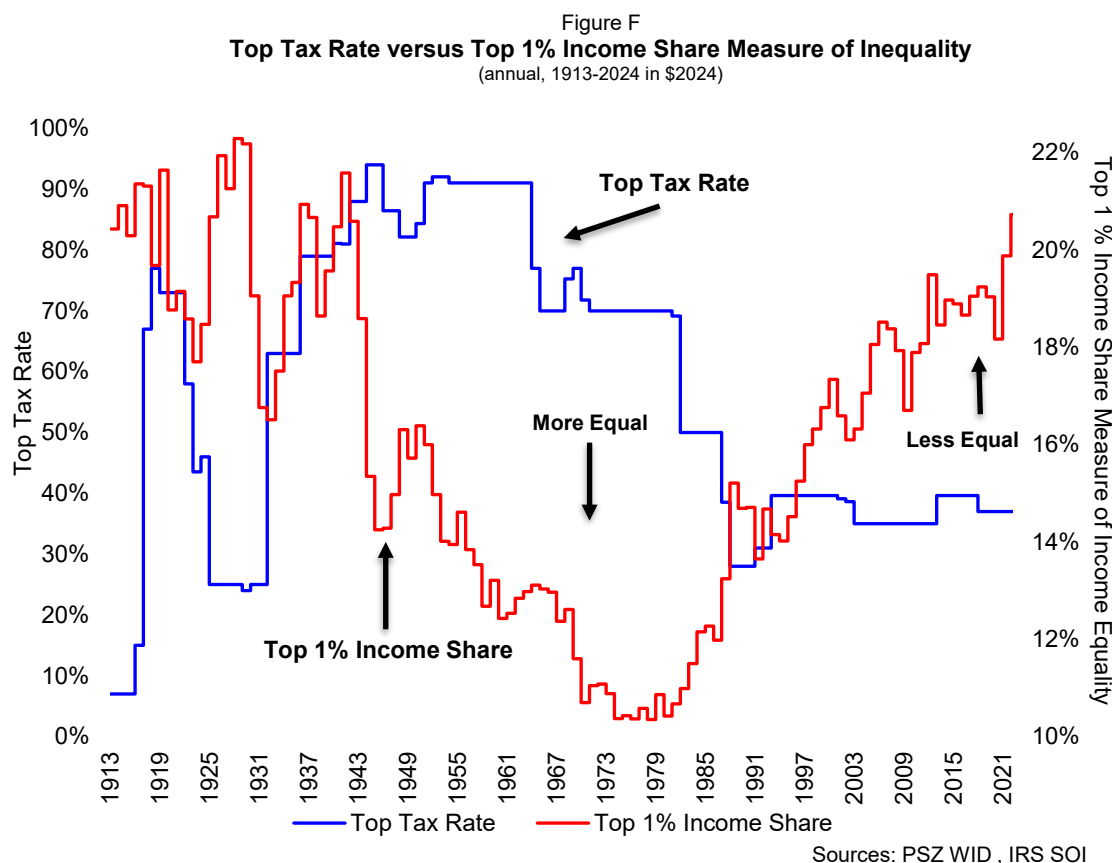
No matter how you slice it or dice it, in today's world, raising top tax rates hurts the poor, even if it were to reduce income inequality.

The Mismeasure of Income Inequality

Professor Emmanuel Saez and his colleague Thomas Piketty are the two standouts advocating for higher top tax rates on the rich and wealth taxes. They have made a career in politics and economics promoting higher taxes on the rich. Using the same data that were used in Figures D, E, and F, shows the share of total pre-tax income accruing to the top 1% of income earners

¹⁶ Martin Feldstein, "Supply-Side Economics; Old Truths and New Claims," AER 72, no. 2 (May 1986), 27; "The Effects of Marginal Tax Rates on taxable Income: A panel Study of the 1986 Tax reform Act," JPE 103, no. 3 (Jun. 1995), 570; "The Tax Reform Evidence from 1986," WSJ, Oct. 24, 2011.

versus the highest income tax rate from 1913 through 2022. This is the relationship which Professor Saez describes as the curve most people attribute to him.¹⁷



If you didn't know better, Figure F convincingly shows that there is a close relationship between income inequality and top tax rates on the rich. When top tax rates rise and are high, they say the distribution of income looks to be more equal while the opposite results from decreases in the top tax rate and low top tax rates. But there are many paths to greater and lesser income equality, some attractive and some ugly as sin.

The question that should be asked is: How is it possible that high top tax rates can be associated simultaneously with lower tax revenues from the rich and greater income equality? High top tax rates on the top one-percenters are also highly correlated with economic underperformance, as measured by growth in total GDP less defense spending—that is growth in spendable income—as seen during periods such as The Great Depression and World War II. How is it possible that income was more equally distributed during the Great Depression, when unemployment rates were over 20% and real wages crashed, than during the Roaring Twenties when the economy boomed, unemployment was minimal, and real wages rose to heights never seen before?

Looking exclusively at Figures D, E, and F, there is a seeming disconnect. But there really can't be a disconnect because the figures are based on the same data. The answer is that there are several different ways to measure income inequality and that the numbers used for this measure of inequality of aggregate reported income don't measure how bad the economy is for lower-level income earners. What these numbers do measure is the sharp fall in reported income of the top 1% due partly to much lower real incomes, as well as sheltering by the rich. These numbers most definitely don't measure what happens to the income of the poor.

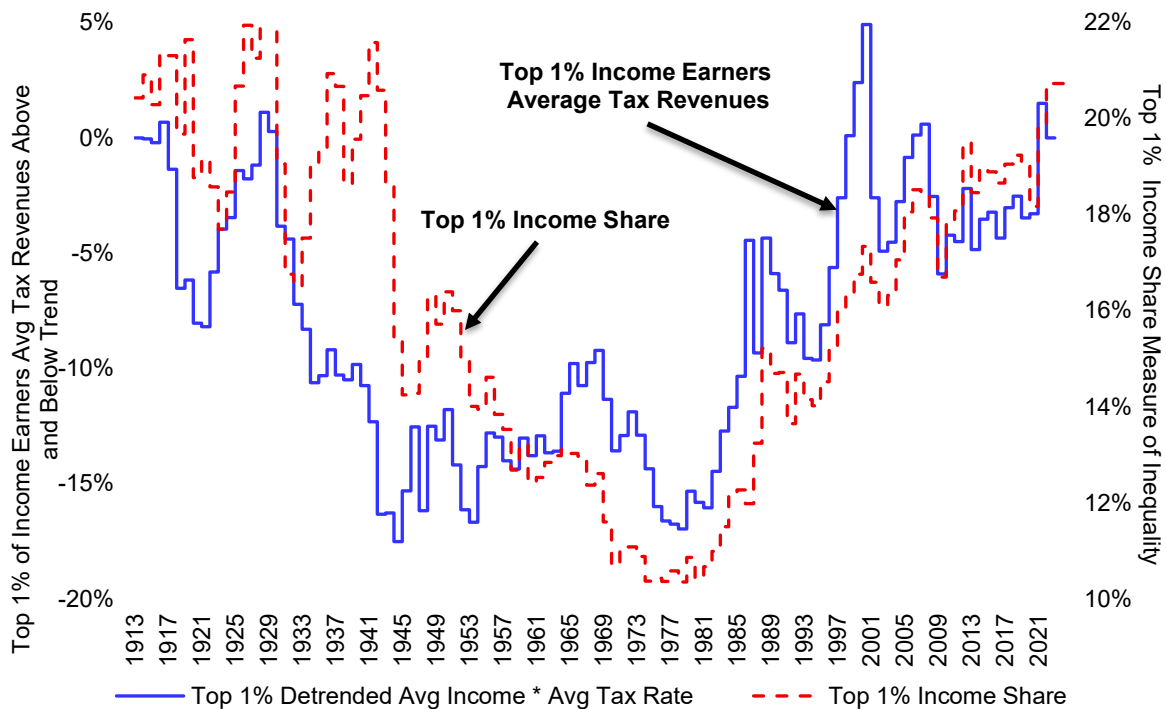
¹⁷ "The 2019 Stone Lecture: Emmanuel Saez" (9:17 mark), <https://www.youtube.com/watch?v=YAPudzTafWo>.

When top tax rates go up, the reported income of the rich goes way down, their tax payments fall, and the poor are destroyed. So much for a more equal distribution of income.

Putting the two relationships together: income inequality versus the top tax rate and real average revenues of the rich versus the top tax rate is the key to understanding the conundrum (Figure G.)

What is absolutely amazing is the closeness of the relationship between average real tax revenues of the top 1% and the share of total pre-tax income accruing to the top one percent of income earners. (Figure G.)

Figure G
Inequality as Measured by the Top 1% Income Share of Total Income Detrended versus the Top 1% Income Earners Average Tax Revenues
(annual, 1913 through 2022)



Sources: PSZ, IRS SOI

As shown in Figure G, when top tax rates go up, the share of income accruing to the rich goes down. It also shows average tax revenues from the top 1% of income earners going down. The correlation is extraordinarily tight (Figure G). Lower top tax rates, on the other hand, are closely linked to higher average tax revenues from the rich and a rising share of pre-tax income accruing to the rich. The reason for the closeness of the fit is clear.

In economics, when something is taxed, people do less of it. Thus, raising top tax rates on reported incomes virtually has to reduce the amount of reported incomes subject to the top tax rate. Therefore, the top one percent's share of total income has to fall. The top tax rate and the top one percent's share of total income are not independent measures of income inequality. And neither measure is directly focused on the economic status of income earners on the lower rungs of the economic ladder. And of course, what we should care about and what should be measured is the standard of living of those who are in the lower echelons of the economic ladder. The dream in America is to help the poor by making their economic circumstances better, i.e. lower unemployment rates, greater wages, more opportunities for advancement, healthier lifestyles, etc. These goals are not advanced by higher tax rates on the rich. It's really quite simple—when top tax rates rise, the rich earn less, shelter more, hire fewer workers, and pay them less. Old bromides such as "I've never been hired by a poor man" or "the best form of welfare is still a good high-paying job" are, in fact, true. You just have to ask yourself how it could possibly be true that the poor could be made better off by raising tax rates on the rich unless tax revenues from the rich increased and were used to help the poor.

According to supply-side critic Robert Reich, President Reagan's tax cuts only created a lot of low-end jobs such as hamburger-flippers. What he didn't say was that these people were no longer unemployed and living on welfare. They were starting a career of employment with advancement in the future. Reagan's era created 20 million net new jobs.

High and rising tax rates on the rich not only reduce average tax revenues from the rich but they also reduce incomes for the entire population. When top tax rates rise, both the rich and the poor get poorer and report less income. But the decline in reported incomes for the rich is greater than is the decline in reported incomes for the lower echelons of the income ladder. As a result, when top tax rates rise, everyone is made worse off. This is shown in Figures F and G. Everyone, as measured by reported incomes, is worse off, but the rich more so than the poor.

The point is simply that the share of reported pretax income is a poor measure of the plight of the less fortunate. In technical terms, this data series exhibits strong multicollinearity with both tax rates and real tax revenues from the rich. In fact, when it comes to tax policy, higher top tax rates almost always hurt the poor.

In a different context, an example will show you exactly what we mean. Back many years ago when people were diagnosed with tuberculosis, doctors recommended that those infected should move to Arizona where the air was dry and warm. The Arizona climate, if not a cure for TB, at least reduced the severity of the disease. As a result of patients moving to Arizona, Arizona had the highest percentage of Tuberculosis in the country. Someone who was unaware of these facts could reasonably conclude that it was Arizona's climate that caused tuberculosis, and therefore people should be discouraged from moving there.

It is the same with income inequality. As tax rates on the rich are raised, the rich shelter their incomes and thus report less income which gives the illusion that income inequality has declined, when, in fact, income inequality hasn't declined, it's just the income numbers from the rich aren't reported anymore.

This crazy relationship between income inequality and top tax rates can be explained by focusing on "standards of living" such as real GDP minus defense spending per capita, as well as reporting anomalies such as the use of tax shelters by the rich and underreporting of incomes of the less affluent. We've covered tax sheltering by the top one percenters quite sufficiently. But, for the lowest incomes there is also a reporting bias that tends to overstate incomes of the poor during bad times. The unemployed and many of the underemployed often earn too little income to be required to file tax returns and, as a result, may be underrepresented in the data. During prosperous periods, more low-income individuals earn enough to appear in the tax records; during downturns, many fall below filing thresholds and effectively disappear from the dataset. This creates a bias toward overstating the incomes of the poorest groups during periods of economic distress. Because unemployment is higher and labor-force participation is lower in bad times, the resulting undercount can be substantial. Consequently, total and average incomes for the poor tend to be overstated more during recessions and depressions than during periods of economic prosperity.¹⁸ These reporting biases—income sheltering among the rich and the non-inclusion of many low-income individuals—can be substantial. What is often overlooked is the extent to which economic hardship among the poor is understated in the data. As a result, periods of economic distress may appear less severe for low-income households than they actually were. High tax rates on top earners are frequently associated with periods in which the real incomes of the poor perform poorly as well. Consider the plight of low-income Americans during eras of exceptionally high top marginal tax rates, such as the Great Depression and World War II.

Whatever the causes, we now have unmasked and exposed the seeming contradiction encased in Professor Saez's measure of income inequality. If you like income equality even when, as shown by our own measures of inequality, it means everyone gets poorer but more so for the rich, you'll like high top tax rates. If on the other hand, you like the poor getting richer, you'll like low top tax rates. A rising tide raises all boats. When tax rates are lower on job creators, there are more jobs available at higher pay. In the words of President John F. Kennedy in December of 1962, "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." If government raises taxes on people who work and increases payments to people who don't work, don't be surprised if you find less people working and more people unemployed.¹⁹

These "factual" conclusions shouldn't surprise any economist. The only way tax policy can make incomes more equal is by making everyone poorer. This is the very essence of The Transfer Theorem!

¹⁸ When low, low, low income people don't file tax returns, this increases average incomes of the lowest filers because those non-filers are not even counted in our data.

¹⁹Address to the Economic Club of New York, Dec. 14, 1962.

The Transfer Theorem

The transfer theorem is as important a component of supply-side economics as any other postulate and is called a theorem because as long as people respond to incentives, it must be true. It is math not conjecture.

A transfer by definition occurs when government takes resources from one group and gives those resources to other groups. When government redistributes income, it takes income (the tax) from someone who earns more and gives the proceeds as a subsidy to someone who earns less. By taxing income from the person who earns more, that person's incentive to produce and report income declines, and they will produce/earn and report income less.

Also, by giving the proceeds from the tax to someone who earns less (the subsidy), that person will now have an alternative source of income other than working and, therefore, will also work less. Any transfer payment to redistribute income will unequivocally reduce total income, and the larger the transfer, the larger the decline in total income.

The reasoning behind this theorem lies in what economists call the Slutsky equation, which breaks down the effects of a price/tax rate change, or transfer into two components: income effects and substitution effects. The substitution effect describes the change in incentives to produce and consume that arises from a change in the relative price of income in terms of not working or producing. Taxes reduce the after-tax return to work, saving, investment, and production. As a result, producers and consumers tend to produce and consume less than they otherwise would. The substitution effects of a redistributive tax/subsidy always work in the same direction for both taxpayers and transfer recipients. In other words, any and all redistributions reduce everyone's incentive to work and thus reduce total income. The income effects (the subsidy to those who earn less) and the income taken from those who earn more, always cancel each other out. The transfer recipient spends more while the transfer payer spends less.

The Achilles Heel of Keynesian economics is that it incorrectly emphasizes non-existent aggregate income effects at the expense of ever-present substitution effects. For example, Lyndon Johnson's chief economist, the late Arthur Okun, wrote in 1975 (when top tax rates went all the way up to 70 percent), his classic primer on Keynesianism, *Equality and Efficiency: The Big Tradeoff*, the following: "Dozens of researchers...have uncovered virtually no significant effects of the present tax system on the amount of work of the affluent...the absence of dramatic effects should not be surprising...Higher income tax rates make leisure cheaper, setting off the substitution effect of trading work for leisure. But meanwhile, they induce people to work more in order to avoid a major cut in living standards, as they reduce take-home pay and exert an income effect." Okun believed that increasing top tax rates on the rich drove them to work harder. When they lose income from high tax rates, they strive all the more to gain income while encountering those high tax rates. This reasoning is simply impossible. Even if we ignore the obvious omissions of tax sheltering, do-it yourself, in-kind payments, etc., we are still left with the obviously wrong inclusion of aggregate income effects resulting from a tax change. If the rich worked just as much despite higher taxes, the additional revenues transferred to recipients would reduce their work effort commensurately, leaving little or no net effect on total income.

The best laymen's illustration of the correct general equilibrium statement (as described above in the paragraph before the Okun example) was written in an April 16th, 1976, editorial in *The Wall Street Journal*:

...M.I.T. economist Lester C. Thurow also speaks favorably of a net-wealth tax and the full taxation of capital gains.

He argues that private capital would still be formed because every tax has an income effect and a substitution effect, and that the former dominates the latter. If you boost the tax on wealth, people will work harder to achieve their desired level of wealth (the income effect), even as the higher tax discourages them from more work (the substitution effect). But by our reckoning, if you tax \$100 from Jones, thus forcing him to work harder, and give the \$100 to Smith, Smith is required to work less to achieve his desired level of wealth.

*The income effect washes out, and all that's left is substitution.*²⁰

How a top highly credentialed economist from one of the best academic institutions could make such a simple mistake is hard to fathom. James Gwartney and Richard Stroup were more attuned in the *American Economic Review* in 1983: "If tax rates are increased in order to enlarge transfer payments, in aggregate, there will be no income effect. Only the substitution

²⁰ Paul Craig Roberts, "Review and Outlook," *The Wall Street Journal*, April 16, 1976.

effect remains, and it will decrease the quantity supplied of labor.” Again Gwartney and Stroup make no mention of sheltering, do-it-yourself, or bartering, but they are 100% correct.²¹

The reason I spend so much effort showing how there are no aggregate income effects of a tax rate change is simple. Without an aggregate income effect, there would be no case to be made for using the tax codes to redistribute income.

As a vivid illustration of the above income and substitution effects, what do you think would happen to an economy if the government took all the output from people who do work and then gave all that output to people who don't work? The economy would go to hell in a handbasket. When redistribution is extended to traits other than income, you will see a vision of Kurt Vonnegut's nightmare described in his short story, *Harrison Bergeron*.

The limit function of this Transfer Theorem is quite obvious once one frames the issue correctly. Imagine the example of complete income redistribution described above where everyone who earns more than the average income is taxed 100% of the excess above the average, and everyone who earns less than the average income is subsidized 100% up to the average. This redistribution is guaranteed to result in perfect income equality. Everyone will have the same after-tax, after-subsidy income regardless of their pre-tax, pre-subsidy income. If everyone who worked, no matter how hard, was only able to receive the average income and everyone who didn't work or worked very little also received the average income, in short order, all income will fall to zero. Perfect income equality. 100% redistribution equates to zero reported income/output.²²

When it comes to economics, complete income equality can only occur when everyone is equally poor. The theory and the data are totally in sync.²³ Raise taxes on the rich and provide income supplements to the poor and you will reduce income inequality by making everyone poorer.

I used to tell my students that if I ran this class the way the government runs our country, I would redistribute grades for equity reasons by giving all the best students failing grades and all the worst students scholarships. But, if I actually did that, my former best students who know the subject matter well would be able to get lower grades than my worst students because they would never make the mistake of guessing a correct answer. The best students would still get all the scholarships, and the worst students would still be flunked out. I would not have changed the distribution of grades one iota. But what would I have done? I would have destroyed the entire quality of the education process. The lesson here is that you can't change the distribution of income with taxes, but you can change the volume of income.

IV. The Full Story

Real Reported Incomes of The Rich and Top Tax Rates

In the following charts, we show exactly what happened when the U.S. increased the top tax rate on the rich and conversely what happened when the U.S. lowered the top tax rate on the rich. We all can imagine a myriad ways by which top tax rates could impact the economy. However, with the massive data set we have, there is no need to guess or opine. We have the data. In English, French, and German, the three most misleading words proffered by supposed experts are “in my opinion,” “à mon avis,” and “nach meiner Meinung.” Policy should be based on facts and only facts.

Figure H and those that follow are based on all federal tax filings from 1913 through 2022 as assembled by the World Inequality Database at The Paris School of Economics and UC Berkeley.²⁴ Here are the facts.

First of all, let's look at what happens to reported incomes from the rich when top tax rates on the rich change. And remember we're talking about reported incomes, which include the consequences from the use of some tax shelters and some tax preferences. Tax sheltering can occur both before income reporting, through the choice of various types of income, as well as after income reporting, by use of deductions, exemptions, credits, write-offs, and omissions.

Figure H plots the highest marginal income tax rate versus the detrended average real income as reported by the top one percent of income tax filers. This figure also shows the date the Smoot-Hawley Tariff was signed into law in 1930. We include

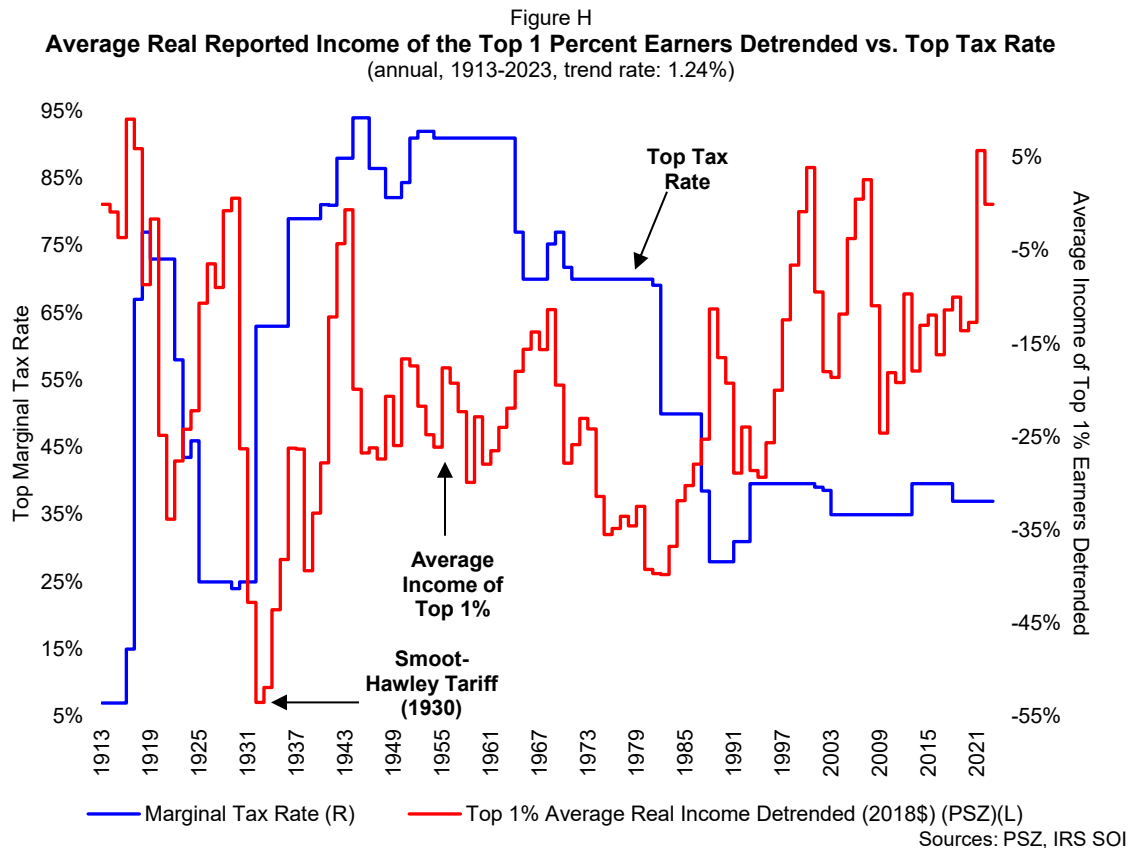
²¹ James Gwartney and Richard Stroup, “Labor Supply and Tax Rates: A Correction of the Record,” *AER* 73, no. 3 (Jun. 1983), 450.

²² “Slutsky Equation,” *Wikipedia*. https://en.wikipedia.org/wiki/Slutsky_equation The Slutsky equation also includes the “income” effects of a tax and subsidy as described above. The “income” effects for the whole economy, as opposed to the “substitution” effects, always cancel each other. The “income” effect for the taxpayer would be positive while the “income” effect for the subsidy recipient is negative.

²³ Kurt Vonnegut in his short story *Harrison Bergeron* describes this phenomenon in all aspects of life.

²⁴ Chancel, Lucas. Piketty, Thomas. Saez, Emmanuel. Zucman, Gabriel. “World Inequality Report 2022”, *World Inequality Lab*, 2022.

this date because the Smoot-Hawley Tariff was by far the largest increase in taxes on traded products in U.S. history. In his acceptance speech for the Nobel Prize in economics in Stockholm, Sweden, Professor Robert Mundell drew the line of causation between the Smoot-Hawley Tariff, The Great Depression, and World War II. Bad policy choices can't get much worse.



When top tax rates rise, real reported average incomes of the rich fall. When top tax rates are high, average reported incomes are low. When top tax rates fall, real reported incomes of the rich rise. And lastly, when top tax rates are relatively low, average reported incomes are high. That's it! The rich, like the rest of us, reduce what they report when faced with higher tax rates.

These changes in reported incomes of the rich as shown in Figure H can result from drops in the true incomes of the rich including from sources such as capital gains, commission incomes, decreased profits from pass-through entities, etc. They can result also from increases in tax sheltering by income earned from interest on state and local bonds which are non-taxable, income averaging, being married and filing a joint return, and having deductions for children, tax deductible gifts to 501(c)(3)s, shifting income into unrealized capital gains, etc. In a notorious example from the 1950s, Mrs. Horace Dodge had the whole of her \$56 million estate in municipal bonds, and not only did she claim no federal tax liability on the interest income stream she did not even have to report the income on her tax return.²⁵ The possibilities for avoiding taxes are unlimited. Do-it-yourself income is also not reportable, as are several forms of barter, and, of course, previous increases in leisure income, such as great art collections and the non-pecuniary returns including from the ownership of sports teams. And then there's also illegal activity of tax evasion—all of those shelters affect the volume of reported income. All of those shelters are also more rewarding the higher top tax rates are.

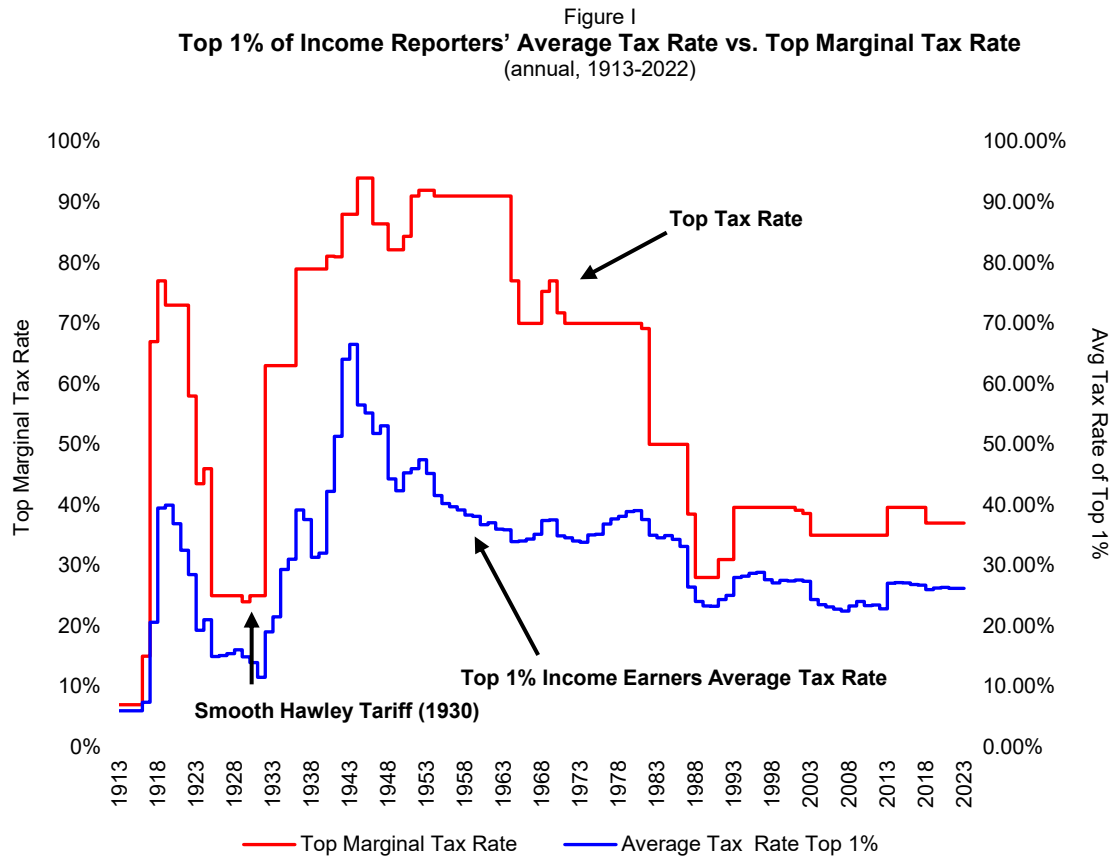
The idea that higher tax rates on the rich lead to lower reported incomes by the rich and vice versa shouldn't surprise anyone. When something is taxed, less of it will be produced and/or consumed. Increase taxes on reported incomes and reported

²⁵ Laffer, Arthur B. Domitrovic, Brian. Sinuefield, Jeanne. "Taxes Have Consequences: An Income Tax History of The United States" *Post Hill Press*, 2022, pg 279.

incomes will decrease. Now let's move on to the second stage of sheltering that occurs between reported incomes and taxable incomes, which when combined with tax rates, yields actual tax payments.

Tax Rates of The Rich

Having described the relationship between average reported real incomes of the top one percenters and the highest tax rate, we now need to see just how changes in the highest tax rate affect the average tax rate of the rich. It is, after all, the average tax rate times the average taxable income that defines the average tax revenue from the top 1%. But it is the highest tax rate that most affects behavior. In Figure I we plot both the average tax rate on reported incomes of the rich and the top tax rate the top one percenters face on the margin. Be aware that the top tax rate is statutory, as are lower official tax rates, while the average tax rate includes behavioral responses—the top tax rate is controlled 100% by the government. Tax filers, on the other hand, can influence to a greater or lesser extent how much income they report and how much they pay in taxes.



Source: IRS SOI

When top tax rates are high, the gap between the top rate and the average rate is very large, reflecting the progressive nature of the tax code and use of tax sheltering. And yet, when top tax rates are much lower, the resultant gap between the top tax rate and the average tax rate is also much smaller, reflecting less need to shelter income.

The average tax rate of the top one percenters as shown in Figure I is nothing more or less than total taxes paid by the rich divided by total income reported by the rich, both of which can be affected by tax filers. In general, the highest tax rate on the rich is far more volatile than the average rate. And, while the highest tax rate may be very high, the average tax rate is much lower. And to repeat ourselves, it is the highest tax rate that most affects behavior, while the average tax rate most affects tax revenues.

When Figure I, the average tax rate paid by high-income earners, is combined with Figure H, which shows the relationship between the top tax rate and the average reported income of the rich, we get the relationship between the top tax rate and the average real tax revenues paid by the rich, shown in Figure D on page 14. C'est ça!

The Kennedy Tax Cuts and Incentive Rates

A short historical example best explains why emphasis should be placed on the incentive rate—one minus the top tax rate—rather than on the top tax rate itself when assessing behavioral changes of the highest income earners.

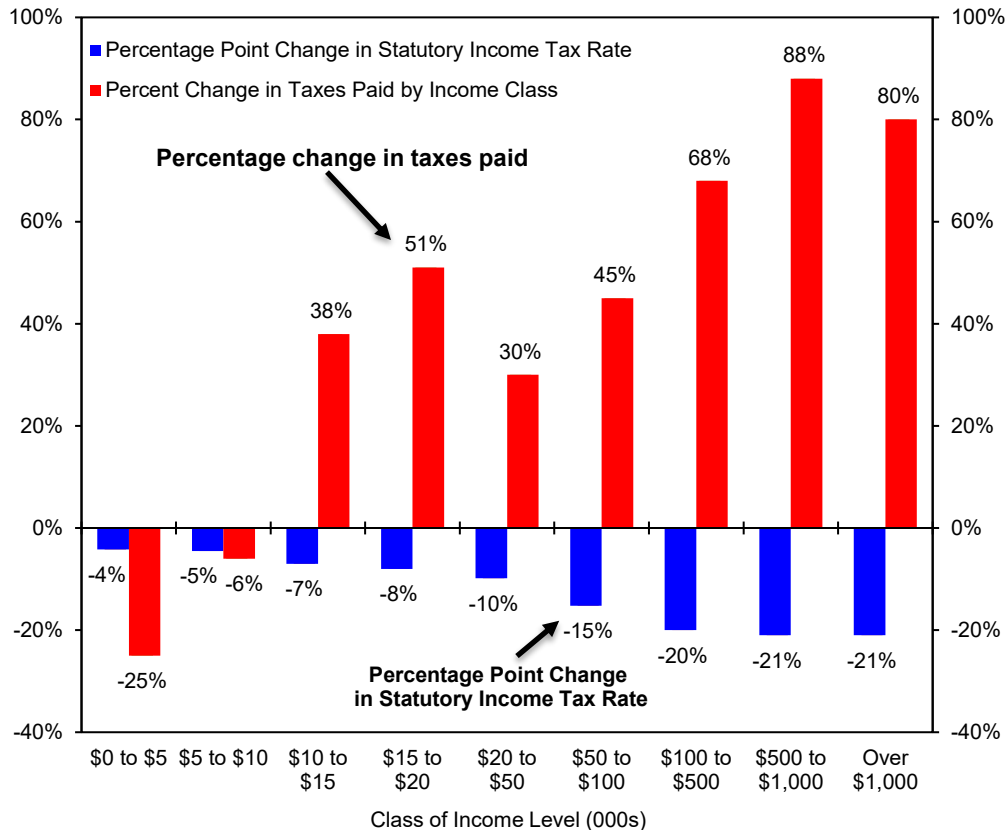
When the Kennedy tax cut passed and was signed into law in 1963, the highest tax rate was dropped from 91% to 70% while the lowest tax rate was cut from 20% to 14%. In terms of static tax revenue calculations, this is a 21-percentage point reduction in the highest tax rate which represents a 23% cut in that rate (21/91). If nothing else changed, tax revenues from this tax bracket of the rich would fall 23%. The lowest rate, however, fell from 20% to 14%, which is a 30% cut in that tax rate (6/20). By itself, that cut would reduce tax revenues from that cohort by 30%.

But now consider these tax cuts in terms of incentives. Prior to the Kennedy tax cut, an income earner in the highest tax bracket was allowed to keep 9¢ on the last dollar earned, and after the cut, that earner could keep 30¢ on the last dollar earned. That is a 233% increase in incentives (21/9) in exchange for a 23% cut in tax rates: a 10 to 1 ratio of incentive increase versus static revenue loss. Not bad.

For the lowest income earner prior to the tax cut, who faced a 20% tax rate the after-tax incentive was 80¢ on the dollar and after the tax rate cut to 14% was 86¢ on the dollar. That represents a 7.5 % increase in incentives (6/80) in exchange for a 30% static tax loss from the cut in rates: a 1 to 4 ratio of incentive increase versus static revenue loss. Not good.

The point of the chart below is simply that, after the massive Kennedy tax cut, growth in tax revenues from higher income earners was a lot greater than growth in tax revenues from lower income earners. The change in after-tax incentives had a magnified effect on tax payments across-the-board.

Figure J
Percent Change in Taxes Paid and Percentage Point Change in Statutory Tax Rate by Income Class from 1963 (before Kennedy cut took effect) to 1966 (after the Kennedy tax cuts were in effect)



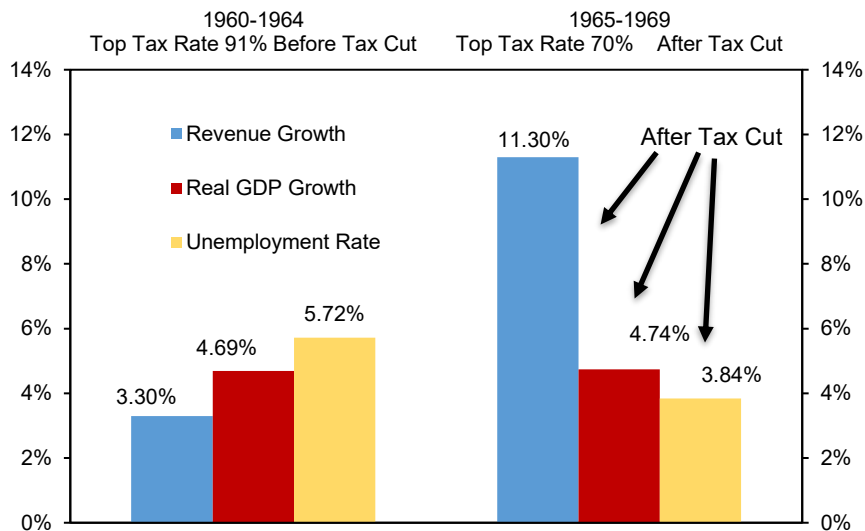
Source: Joint Economic Committee

In his tax bill, President Kennedy also shortened the depreciable lives for plant and equipment expenditures and enacted a 7% investment tax credit to increase incentives to save and invest.

In addition to all his personal income tax changes, President Kennedy reduced tariffs by some 35% in an international agreement carrying his name, and cut the highest corporate income tax rate from 52% to 48%. He had originally proposed cutting the personal income tax rate to 65% and the corporate tax rate to 46%, but this was blocked by Republicans led by Senator Barry Goldwater.

Using our example of the Kennedy tax cuts, for the period 1960-1964 with the top tax rate at 91%, tax revenues grew by 3.3%, real GDP grew by 4.7%, and the unemployment rate stood at 5.7% (see Figure K). For the period 1965-1969, after cutting the top rate to 70%, as well as tax rate cuts in other tax brackets including the corporate tax rate from 52% to 48%, tax revenues grew 11.3%. Real GDP grew at 4.7% and unemployment averaged 3.8%.

Figure K



Sources: BLS, BEA

In congressional testimony, Walter Heller, President Kennedy's Chairman of the Council of Economic Advisors stated, "What happened to the tax cut in 1965 is difficult to pin down, but insofar as we are able to isolate it, it did seem to have a tremendously stimulative effect, a multiplied effect on the economy. It was the major factor that led to our running a \$3 billion surplus by the middle of 1965, before escalation in Vietnam struck us. And within one year the revenues into the Federal Treasury were already above what they had been before the tax cut...Did it pay for itself in increased revenues? I think the evidence is very strong that it did."²⁶

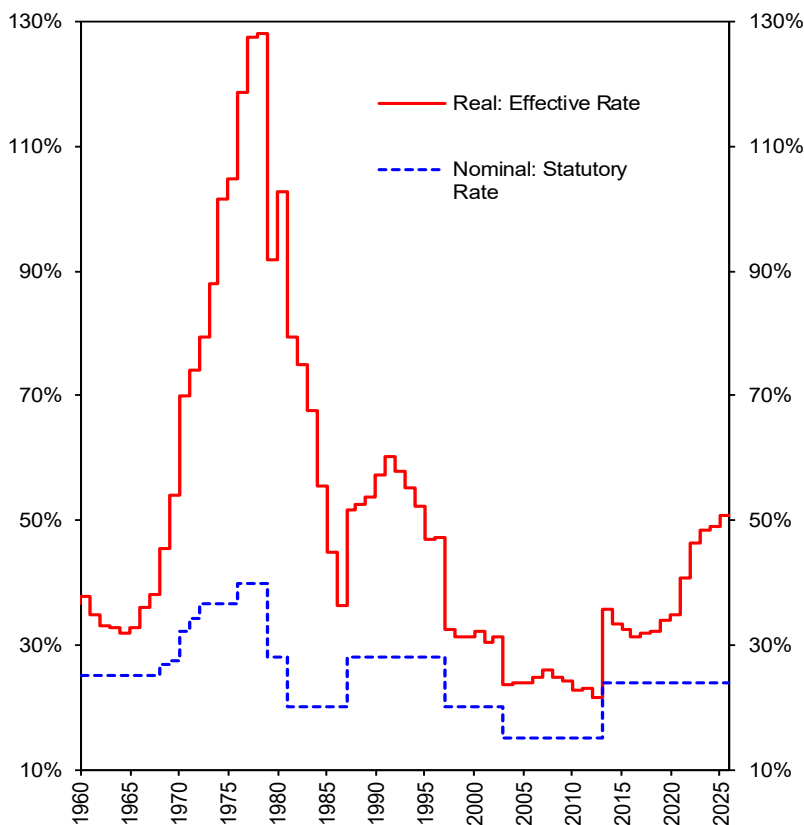
The Special Case of Capital Gains

It should be noted that during the period from 1969 through 1981, there was a tax distinction made between earned income (wage and salary) and unearned income (capital gains, dividends, royalties, and interest). The former was taxed at a top tax rate of 50% while the latter was taxed at a top rate of 70%. The tax return calculation for taxation on realized capital gains at that time was to tax 40% of the total capital gains at the top unearned income tax rate, i.e. the top tax rate for capital gains is $(1 - .6) \times 70\%$ or 28%. Given the horrendous inflation of the mid to late 1970s along with a tax code that was not indexed for inflation, the effective tax rates on capital gains soared often to well over 100%. See Figure L which shows the actual inflation adjusted top tax rate on real capital gains. Two features of Figure L are exceptionally noteworthy. First, the longer an asset is held, the greater the difference between the statutory tax rate and real effective tax rate. And the second feature is the higher the real return in re capital gains, the less is the distortion.

²⁶ Bruce Bartlett, "Supply Side Economics: 'Voodoo Economics' or Lasting Contribution?" Laffer Associates, November 11, 2003.

To see how bad the state of the economics profession had become once Reagan took office, Walter Heller changed his answer screaming that Reagan's tax cuts were different and would cause hyperinflation, economic collapse and large budget deficits. Not only was he a hypocrite but he got it exactly backwards.

Figure L
Inflation and the Capital Gains Tax Rate: Nominal and Real*
 (annual, period: 1960 to 2025, maximum long-term rate used, federal taxes only)



*Assumes annual 5% real yield on investment held for 5 years according to BLS tax code

Sources: Laffer Associates, BLS Tax Code

In addition to inflation's impact on the real effective capital gains tax rate, "Bracket Creep" due to inflation raised all marginal tax rates, leading to collapsing average real tax revenues for the top one percent of income earners (Figure E and L). There was never a period in U.S. tax history where the need for tax sheltering was greater.

In the 1978 Steiger/Hansen tax bill there were cuts in capital gains statutory tax rates, and there were also cuts in tax rates on unearned income. The drop in inflation starting really in 1981 led to a drop in illusory capital gains, which when combined with the statutory tax cuts resulted in a surge in total tax revenue (Figure E). Tax cuts, whether from lower inflation or lower statutory rates increase revenues.

When government directly or indirectly (via inflation) raises tax rates on the rich, tax revenues from the rich don't go up, they fall! Raising tax rates on the rich hurts everyone—the rich, the economy, government tax revenues, state and local government solvency, and the poor. It was no fun being poor when tax rates on the rich were sky-high such as World War I, The Great Depression, and World War II. Keeping top tax rates high not only extends the damaging outcomes over longer periods of time, but by all accounts, those damaging outcomes continue to get worse and worse year after year. But on the brighter side, lowering tax rates on the rich and keeping those top tax rates relatively low creates and extends prosperity. Just look at real average tax revenues from the rich beginning in 1983 on through to the present. It's amazing how much and how fast average tax revenues from the rich grew (Figures D on page 14 and E on page 17).

The simple lesson is that in a high tax rate environment, raising tax rates on the rich may feel good, but it is an equal opportunity destroyer of all that is good in an economy. Chickens should not vote for Colonel Sanders.

Additional Effects of Inflation

Prior to 1985 when President Reagan's 1981 ERTA legislation indexed individual income tax brackets for CPI inflation, there literally weren't any automatic adjustments for inflation. As a result, increases in a person's income brought about by inflation were taxed at that person's highest marginal tax rate. Depreciation schedules for business investments allowed for deductions on business tax returns over the life of the asset based solely on the actual dollar price paid for the asset. As inflation pushed replacement costs higher and higher, however, the value of those depreciation deductions failed to keep pace. The increasing discrepancy between the dollar value of the depreciation and replacement cost was an effective increase in business tax rates due exclusively to inflation and depreciation schedules.

The negative effects of price controls, minimum wages, tax thresholds, property taxes, and regulatory practices all increased as a consequence of inflation. These effective "tax" increases were significant deterrents to prosperity and only kept increasing over time. But the biggest inflation tax increase of all was most likely the tax on long-term realized capital gains.

I bought my first home in Chicago in 1968 for \$39,500. By 1978, my home in southern California was worth about \$2,000,000. By law, capital gains from selling a home used for buying another home of greater value would not be taxed currently. That capital gain would be "rolled over" into the new house as an increase in unrealized capital gains, thus conferring on the current home the original tax basis. In my case, my home in California had my tax basis still set at \$39,500. If I had sold that home prior to the 1978 Steiger-Hansen tax cut, I would have had a federal capital gains tax bill of about 48% (\$941,040) and an add-on California capital gains tax bill at 11% (\$215,655), adding up to a total capital gains tax of \$1,156,695. This would have left me with a net gain after tax of a smidgen over \$800,000. But with a mortgage on a \$2,000,000 home of over \$1,000,000, selling the home would be a huge cashflow problem. This is called the locked in effect of capital gains taxation. People in my circumstances prior to the Reagan tax cuts could not afford to sell their homes and unlock the unrealized capital gains because of the impending tax liability. Passage of the Steiger-Hansen tax cut greatly reduced this penalty and then when President Clinton took office, taxes on the capital gains from the sale of owner-occupied homes were drastically lowered.

Inframarginal Tax Rates

Very few income earners face the lowest bracket's tax rates as their marginal tax rates and yet all taxpayers pay the lowest tax bracket's tax rate on part of their taxable income. The highest income earners pay taxes in each and every tax bracket up to, and including, the bracket where they pay their marginal tax rate. For those people in the higher tax brackets, the tax rates applicable to the lower income tax categories are what we economists call *inframarginal* tax rates. Inframarginal tax rates have no incentive or substitution effects inducing people to earn more or less income. The lower the tax bracket, the smaller the percentage of total taxpayers who pay that bracket's tax rate on the margin and, conversely, the more taxpayers there are for whom that tax rate is *inframarginal* (in the 1964 Kennedy tax cut, the largest percentage rate cut actually came in the bottom rate. Its reduction from 20 to 14 percent, or 30 percent, was the biggest rate cut of that law. The top rate reduction of 91 to 70 percent was in comparison a 23.1 percent cut). In Table 2, I have listed for calendar year 2005, the marginal tax rate for each tax bracket, the number of tax returns where that tax bracket is the marginal tax rate, the percentage of all returns that pay taxes in that tax bracket at that tax rate, and lastly, the percentage of all returns in that tax bracket that pay that tax rate as their marginal tax rate. While more recent tax return data results are not as extreme as this 2005 example, the principles are exactly the same.²⁷

Focusing on Table 2, consider the following: 100% of those earners in the highest income tax rate bracket face the highest tax rate of 35% as their marginal tax rate and therefore directly benefit in incentive terms from a tax rate cut for the top tax bracket. In 2005, only about 1% of taxpayers who pay taxes in the lowest bracket where the tax rate was 5% actually faced the lowest tax rate as their marginal tax rate and thus benefitted in incentive terms from a tax rate cut to the lowest tax bracket. Stated differently, 99% of income taxpayers who pay taxes in the lowest bracket do *not* face the lowest tax rate as their *marginal* tax rate and are therefore unaffected in incentive terms from cuts in the lowest tax rate. Out of every dollar in taxes collected in the lowest tax bracket, over 99 cents comes from higher income earners, not those who are actually on the margin in that bracket. Rhetoric aside, cutting the lowest tax rate reduces the tax bills of higher income earners far more than it reduces the tax bill of the lowest income earners. Based on only economics (i.e., not politics), a good way to raise tax revenues that does the least damage to incentives is to raise the lowest tax rates.

²⁷ Arthur B. Laffer, "Government Exactions and Revenue Deficiencies," in *Supply-Side Economics: A Critical Appraisal*, ed. Richard H. Fink (Frederick, Maryland: University Publications of America, 1982), 197.

For high income earners, lowering tax rates applicable to lower income tax brackets will have anti-growth individual income effects and virtually no pro-growth incentive effects. As a result, cutting tax rates in ever lower income brackets will progressively create greater and greater deadweight losses for government tax revenues and yet will influence only fewer and fewer people's decisions to increase their amount of taxable income through output or tax sheltering responses.

Table 2
2005 Tax Filers by Tax Bracket²⁸

Highest Tax Rate	Tax Returns On The Margin	Percentage of Total Returns	Percentage of Remaining Filers Paying This Rate for Whom it is the Marginal Rate**
5%	1,186,478	1.14%	1.14%
8%	651	0.00%	0.00%
10%	25,508,822	24.45%	24.73%
15%	49,321,395	47.28%	63.54%
20%	2,960	0.00%	0.01%
25%	21,996,816	21.09%	77.72%
28%	3,730,002	3.58%	59.17%
33%	1,479,592	1.42%	57.48%
35% ²⁹	1,094,617	1.05%	100%
Total	104,321,333	100%	

The key takeaway here is that higher income earners pay taxes in lower income tax brackets, and a cut in tax rates in lower income tax brackets disproportionately lowers taxes for higher income earners. In other words, by leaving the high-income earner's marginal rate the same, but giving the individual more after-tax income (via the inframarginal tax rates cuts), the high-income earner now has less of an incentive to continue working and producing (the income effect). Maximizing incentive gains while minimizing static revenue losses means raising the lowest tax rates and lowering the highest tax rates up to the point where we have a flat tax. Every taxpayer would face the exact same single tax rate. The closest the U.S. ever came to achieving a truly low-rate broad based flat tax was the period immediately following the passage of the 1986 Tax Cut. In that bill, the top tax rate was reduced from 70%, where it stood when President Reagan took office, to 28% when he left office. The only other personal income tax rate, i.e. the lowest tax rate, was raised from 12.5% to 15%, and the corporate tax rate was also lowered from 46% to 34%. All the while, deductions, exclusions, credits, write-offs, and omissions were removed until the net static effect of the bill was revenue neutral. Fourteen tax brackets became two and 97 senators voted for this bill that President Reagan signed in 1986. How's that for egg-in-your-beer?

One longstanding critic of the supply-side revolution, Martin Feldstein, who as President Ronald Reagan's Chairman of the Council of Economic Advisers in the mid-1980s had advised raising top tax rates, later came to recognize the effectiveness of the Tax Reform Act of 1986 after observing its clear empirical results. In the *Wall Street Journal* in 2011, Feldstein wrote of the 1986 tax act:

"Traditional 'static' analysis that ignores the response of taxpayers to lower tax rates indicated that those combined tax changes would leave total revenue unchanged at each income level. But the actual experience after 1986 showed an enormous rise in the taxes paid, particularly by those who experienced the greatest reductions in marginal tax rates....

"Taxpayers who faced a marginal tax rate of 50% in 1985 had a marginal tax rate of just 28% after 1986, implying that their marginal net-of-tax share rose to 72% from 50%, an increase of 44%. For this group, the average taxable income rose between 1985 and 1988 by 45%, suggesting that each 1% rise in the marginal net-of-tax rate led to about a 1% rise in taxable income.

²⁸ Source: IRS Statistics of Income, Table 3.4: Returns with Modified Taxable Income: Tax Classified by Both the Marginal Rate and Each Rate at Which Tax Was Computed. <https://www.irs.gov/uac/soi-tax-stats-statistics-of-income>

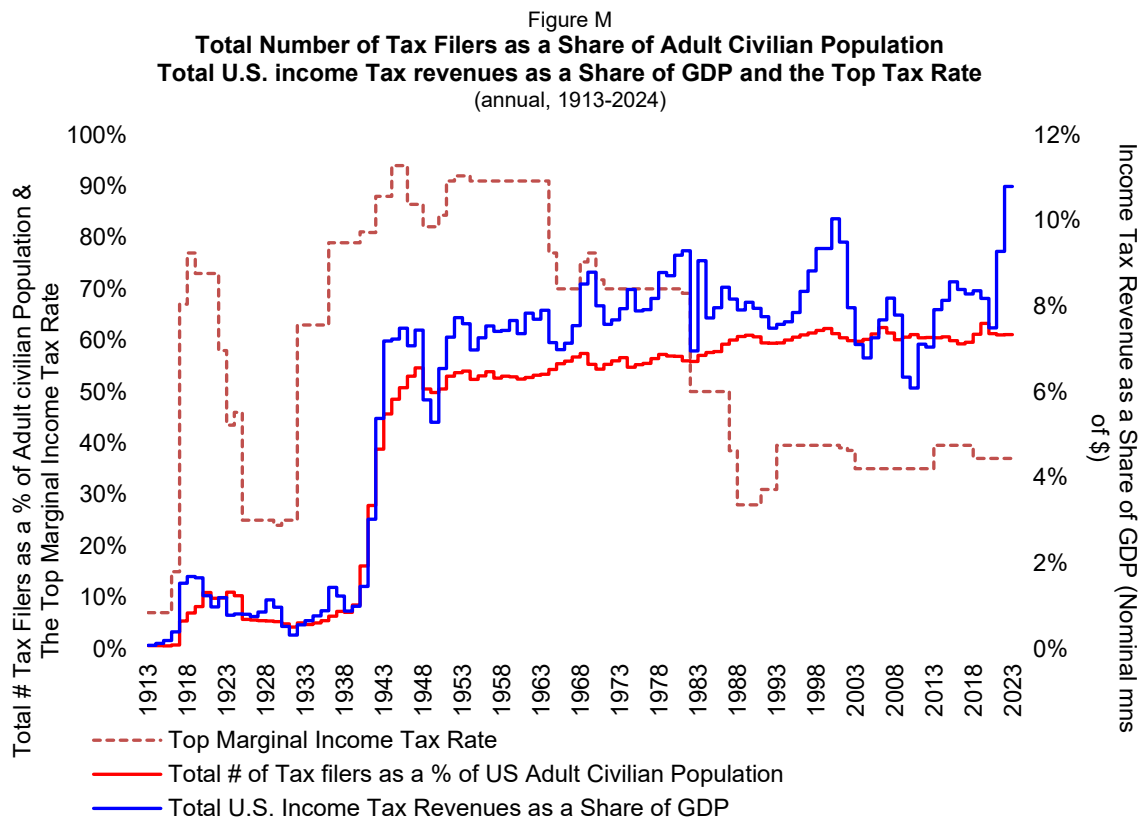
²⁹ This category also includes 141,612 tax returns of people who use form 8615 which includes the Alternative Minimum Tax and the associated tax returns of people 18 and under who pay tax rates in their parents' bracket.

"This dramatic increase in taxable income reflected three favorable effects of the lower marginal tax rates. The greater net reward for extra effort and extra risk-taking led to increases in earnings, in entrepreneurial activity, in the expansion of small businesses, etc. Lower marginal tax rates also caused individuals to shift some of their compensation from untaxed fringe benefits and other perquisites to taxable earnings. Taxpayers also reduced spending on tax-deductible forms of consumption."

Feldstein concluded that deficit-reduction in 2011 was actually easy as pie (if only Congress would summon the sense to enact it). The tax base should be broadened, as tax rates were cut to the same degree on a static revenue basis. Then revenue would come in higher, just as after 1986, because of increases in tax receipts from the highest earners paying at lower rates. He all but endorsed the Laffer curve by name and found it vindicated in the greatest of all of Reagan's tax cuts.³⁰

Total Tax Revenues

In order to fully understand how taxation of the rich fits into the overall fabric of income taxes, we need to look at the big picture. In Figure M, we plot, I.) total federal income tax revenue as a share of Gross Domestic Product, II.) the number of tax filers as a percent of the adult population, and III.) the highest tax rate. What was a relatively minor source of tax revenues for the federal government from 1913 through say 1941, the income tax grew to be the behemoth we know it to be today.



In Figure M, starting with the period right after WWII, you can see how total income tax revenues as a share of GDP gently rose to its present level. You will also see that during this period the number of filers as a share of the total adult population also increased slowly. But in stark contrast, the top tax rate on the top one percenters fell precipitously from a high of 94% in 1944 to a low of 28% in 1987, on to its present level of 37%. How are sharp cuts in the highest tax rates and increases in tax revenues as a share of GDP compatible? How is it even possible? Easy. Lower the tax rate on the rich, increase tax revenues. From the standpoint of aggregate income tax revenue as a share of GDP, lowering the highest tax rate had, if anything, a mildly positive impact on tax revenues.

³⁰ Martin Feldstein, "The Tax Reform Evidence from 1986," *The Wall Street Journal*, October 24, 2011.

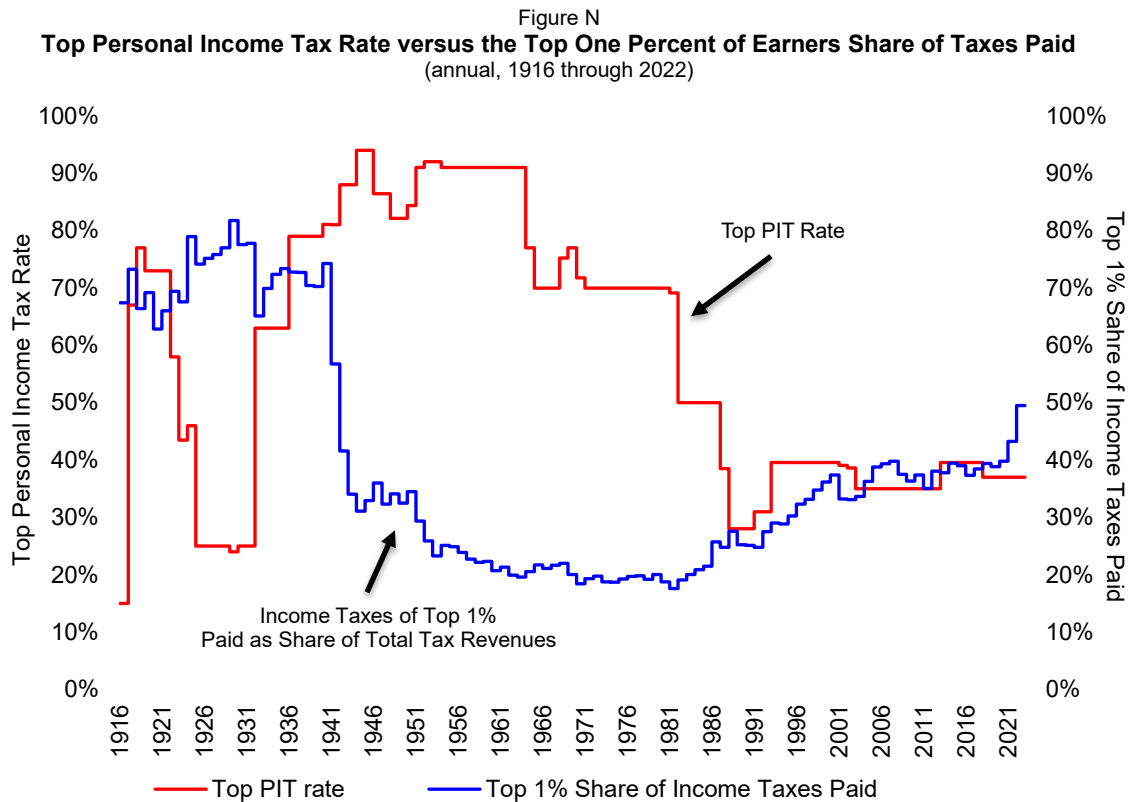
The number of people required to file tax returns along with tax rates, exemptions, omissions, credits, write-offs, and deductions for filing are always important in determining total federal tax revenues. It's simply math. But there are times, however, when tax thresholds are dominant. In 1913, for example, with the top tax rate set at 7%, only some 358 thousand entities were required to file tax returns (out of an adult population of 66 million) and the average tax rate of the top 1% was 6%. By 1918, with the top tax rate raised to 77%, the number of filers popped up to 4.425 million and the average tax rate of the top 1% rose to 39.5%. The number of filers kept rising, finally peaking in 1920 at 7.26 million filers. Obviously, total tax revenues as a share of GDP rose too (Figure M).

But after 1920 and the disastrous electoral defeat of the high-tax democrats, at the hands of promised tax cuts, both tax rates and the number of filers crashed. In the boom years leading up to 1929, before the consequences of the Smoot-Hawley Tariff were felt, only 4.133 million people were required to file and the top tax rate had been lowered to 24%. This period was called the roaring twenties with enormous growth, declining poverty, and eleven straight years of federal budget surpluses. And so, the story goes.

And then there was the huge increase in the number of filers from 7.7 million in 1939 to 50 million in 1945. Huge increases in the number of filers had quite an impact on the size and composition of federal income tax revenues (Figure M). As a final comment on Figure M, look at the period starting 1963 up to the present. Top tax rates fell first from 91% in 1962 to 70% in 1963, then to 50% in 1981, down to as low as 28% in 1987 after which low rates remained. Throughout this whole period of falling tax rates, total tax revenues as a share of GDP continued to rise. Based on these data it is difficult to justify high top tax rates from the standpoint of total tax revenues. This is the real story of the federal income tax.

There are basically two ways government has tried to increase its tax take relative to the size of the economy: take a lot from the few rich people by raising top tax rates or take lesser amounts from each member of the vast multitudes. Raising top tax rates has never worked for very long except at very low tax rates. As tax rates rise on the rich, the rich find ways to avoid those higher tax rates. When tax rates rise on the masses, they have little recourse to tax shelters or tax return experts. They simply pay more in taxes. But when they hit a tax ceiling, their only response is to simply "throw the bums out." All in all, the income tax in the U.S. has way passed its prime. Current attempts to raise the income tax by raising rates on the rich are self-defeating and toxic. The only ways to increase tax revenues are first to lower the highest tax rates on the rich, then raise tax rates in the lowest tax brackets, eliminate as many deductions as possible, and finally increase the tax base by including everyone at the lowest tax rate. Higher tax revenues both from the rich and from faster growth are caused by lower tax rates on the rich. Robin Hood remains a charming children's story, but with no grounding in facts. To repeat ourselves, a country can't be taxed into prosperity, nor can a country become rich by overtaxing the rich.

Figure N shows total (not the average as shown in previous figures) personal income tax revenues of the top one percenters by year as a share of all income tax revenues.



Prior to 1941, total income tax revenues as a share of GDP were small and only the very few were even required to file tax returns, and all filers back then were among the highest income earners in the land. In general, under more reasonable tax rate regimes, the richest of the rich paid a large share of total taxes which were only collected from the rich (the non-filers paid nothing). When top tax rates were too high, the tippy top of the highest income earners found tax shelters. The data speak volumes.

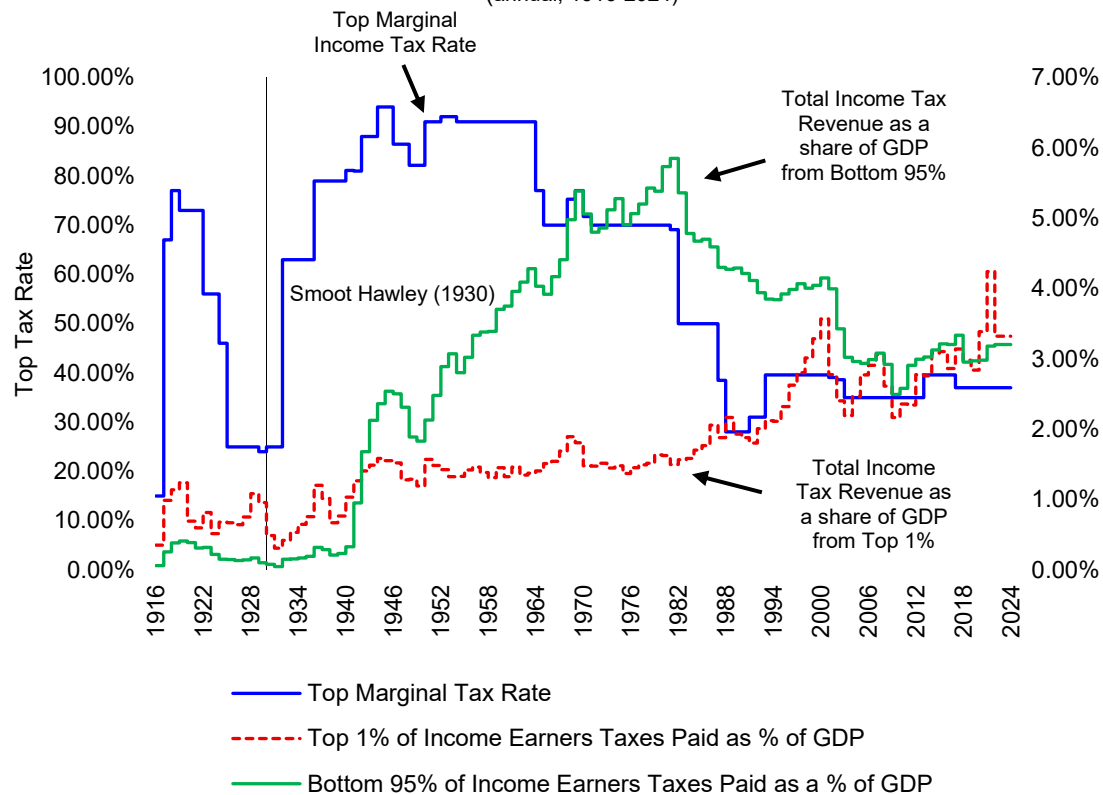
But in the years around 1941 the government extended the income tax to more and more people with lower and lower incomes (see Figure M and N), all the while keeping high or raising tax rates on the rich. From those days on up until the Reagan revolution of massively lower tax rates on the rich, the top 1% share of total taxes collapsed, taxpayers in the lower echelons of income paid more of total taxes while the rich paid less as a share of total tax revenues (Figure N).

In sum, based on all U.S. tax returns from 1916 through 2022, Figure N shows that when the highest income tax rate on the top one percent of income earners rises, the share of total income taxes paid by that top one percent falls. When the highest tax rate is high, tax revenues collected from the rich as a share of total tax revenues are low and continues falling. When the top tax rate falls, the share from the rich rises, when the top tax rate is relatively low, the share of tax revenues from the rich is high and continues rising for long periods of time. In French: *Maintenant je suis content, on a la preuve.* (Now I am satisfied, we have the proof.)

What is absolutely astounding is how the top 1%'s share of total taxes paid troughs in the late 1970s and early 1980s and then soars. After that point top tax rates fall dramatically due to legislated changes—Steiger/Hansen (1978) and the 1981 tax act called ERTA (Economic Recovery Tax Act)—along with falling inflation and its effect on illusory capital gains, bracket creep, asset depreciation regulations and thus taxes. From 1980 on the top 1% share of taxes paid takes off like a jack rabbit from about 15% of total taxes collected to well over 50% (Figure N). And the components of this seismic change included rapidly rising tax revenues from the rich and equally dramatic declines in tax revenues from everyone else. What could possibly be better?

In Figure O, we plot total tax revenues from the top one percent of income tax filers and from the bottom 95% of tax filers both as a share of GDP versus the top rate. The points made earlier are shown in stark relief.

Figure O
Top 1 Percent and Bottom 95 Percent Tax Revenues as a Share of GDP vs. The Top Marginal Tax Rate
 (annual, 1916-2024)



Once again, the folly of raising the top tax rate too high pops off the page. With the Smoot-Hawley Tariff of 1930, closely followed by top tax rate increases to 63% and higher from 1932 through 1981, revenues from the top 1% remained below 2% as a share of GDP (Figure O). But during the period starting in the early 1940s when the tax rolls were greatly expanded, tax revenues from the bottom 95% of income earners soared from a little less than 1% of GDP to almost 6% of GDP in 1982. Once the top tax rate was dropped starting in 1982 and kept dropping, tax revenues from the bottom 95% of income earners as a share of GDP fell to about 3%, while concurrently revenues from the top one percent rose to almost 4% of GDP. Doesn't that just tell the story?

Costs of Collection

There is at least one additional consideration in this discussion that needs to be made. The out-of-pocket costs of collecting taxes from the perspectives of both taxpayers and tax collectors can be very substantial and can make or break tax policies. The costs paid by taxpayers and tax collectors (IRS) including taxes paid are far greater than the net sums the government collects.³¹ To use a phrase from the legendary songstress Cher, what you think you see is far more than what you actually get. Individuals and businesses as taxpayers must pay a lot more than \$1 in order for government beneficiaries to receive \$1 of federal government services. And, just for the record, \$1 spent by government departments and agencies are expensive for program recipients to receive. It's all a vicious cycle.

The point being made here is superbly important and has been totally neglected. The question that needs to be answered is what the total costs are, all in, to collect one dollar of useable tax revenues across the vast range of tax options. The answer is far from obvious.

Before individuals and businesses pay their tax liability, they must first spend time collecting records, organizing files, and wading through the tax code to determine exactly what their tax liability is. In addition, individuals purchase products and services, such as tax software or an accountant, to assist them in determining their tax liability. These are tax compliance

³¹ For more on this topic, see: Arthur B. Laffer, Wayne H. Winegarden and John Childs, "The Economic Burden Caused by Tax Code Complexity," The Laffer Center for Supply-Side Economics, April 2011.
<http://www.laffercenter.com/wp-content/uploads/2011/06/2011-Laffer-TaxCodeComplexity.pdf>

outlays. Thirdly, in effect, taxpayers must also pay the administrative costs needed to run the IRS etc., solely for tax collection purposes. Still, there is more.

Individuals and businesses, large and small, hire teams of accountants, lawyers, and tax professionals to track, measure, and pay their taxes. This tax infrastructure is also used to optimize the tax liability of the taxpayer. Individuals and businesses change their behavior in response to tax policies, hiring tax experts to discover ways to minimize their tax liabilities. The efficiency costs from both legal tax avoidance and illegal tax evasion are difficult to quantify but could be the highest costs of all.

In recent times, President Trump eliminated income taxes on tips paid to service personnel such as waiters and waitresses etc. I thought this was a great idea. Who wants the government to spend a billion dollars to try to collect a million dollars? It simply doesn't make sense.

"Oh, no," said the Governor of Colorado, Jared Polis, to me on stage on this matter at an event in the summer of 2025 at the glorious Broadmoor Hotel in Colorado Springs. Here in Colorado, said the governor, we have made all tips electronic, so there is no question of their being reported. It's as easy and as cost-effective as anything.

Um, governor, the Broadmoor here is stacked with porters, drivers, maids, clerks, and staff, several of whom just as we left the stage and collected our luggage produced a roll of fives and tens from their pockets to make change for big bills for forthcoming tips. The Broadmoor is choked with service staff raking in cash tips. Not a moment separated our event on stage and the collection of profuse cash tips. We've gone electronic, my eye. Where there's a will, there's a way.

One can only imagine what the full burden of government on the well-being of society might be. In a paper I co-authored with John Childs and Wayne Weingarten, we estimate that U.S. taxpayers paid out-of-pocket \$437.1 billion in 2010, or 30 percent of total income taxes collected, just to comply with and administer the U.S. income tax system.³² This cost estimate in 2010 dollars includes:

- Approximately \$31.5 billion in direct outlays (e.g. paying a professional tax preparer such as H&R Block or purchasing tax software) (2010 data).
- Total IRS administrative costs of \$12.4 billion (2010 data).
- The Taxpayer Advocacy Service of the IRS estimates that individuals and businesses also spent 6.1 billion hours complying with the filing requirements of the U.S. income tax code. We estimate the dollar value or cost of these hours to be \$377.9 billion as of 2008. The 6.1 billion hours number was estimated by multiplying the number of copies of each form filed in tax year 2008 by the average amount of time the IRS estimated it took to complete the form.
 - Individuals spent 3.16 billion hours complying with the income tax code, which weighted by time spent by income group, costs the U.S. economy \$216.2 billion annually.
 - Businesses spent 2.94 billion hours complying with the business income tax code, which cost the U.S. economy \$161.7 billion.
 - Comprehensive audits also impose an additional taxpayer burden of at least \$9.3 billion annually.

Putting all of these costs together with the rest of our analysis leads to the conclusion that it is far less costly to cut tax rates on people who do work than it is to give money to people who don't work.

No business on Earth could survive if it cost more than a dollar to produce a dollar in revenue. Only governments can do that.

Conclusion

Why anyone would want top income tax rates over 28% is beyond reason. High top tax rates hurt the overall economy, lose tax revenues from the rich, encourage higher taxes on lower incomes, and worst of all make the poor poorer. If data are

³² According to the IRS, total gross individual income tax collections in 2008 were \$1.4 trillion (<http://www.irs.gov/pub/irs-soi/08db01co.xls>); Although as of this writing total tax collections from 2010 are available, the detailed breakdown of income taxes paid by adjusted gross income are only available through 2008. For consistency, data on tax collections from 2008 are used throughout this study.

followed, the most obvious implication according to best practices, the most extensive database ever, and time tested total theory is that the best tax is a low rate, broad based flat tax. Low rates provide little incentive for income earners to evade, avoid, or otherwise not report taxable income and a broad base removes all sorts of places where income earners can place their incomes to avoid taxes. A low rate, broad based flat tax is by all intents and purposes fair. If you and I live and work by the same rules and you make 15 times as much as I do, you should pay 15 times as much as I do in taxes, but not 50 times as much. A low rate, broad based tax system also saves lots and lots of money due to efficiencies of operation. Businesses would collect and pay the taxes owed by employees, owners and consumers, not those individuals themselves. People are not nearly as facile with finances as are businesses.

Again, one of the best examples of good tax policy was to be found in Reagan's 1986 Tax Act—winning with a truly great tax bill is the best of all worlds.

What high tax rates on the rich enmeshed in volumes and volumes of convoluted, complicated, and confusing tax codes do accomplish is they erect virtually insurmountable barriers against those who are not rich from accumulating wealth and becoming rich. High tax rates, whether they are meant to or not, keep lower-level income earners from ever becoming wealthy.

