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There's No Escaping Hauser's Law

Tax revenues as a share of GDP have averaged just under 19%, whether tax rates are cut or raised. Better to cut rates and get 19% of a larger pie.

By W. KURT HAUSER

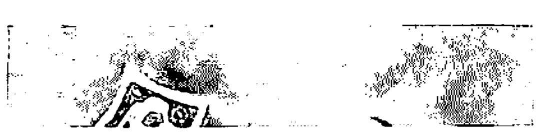
Even amoebas learn by trial and error, but some economists and politicians do not. The Obama administration's budget projections claim that raising taxes on the top 2% of taxpayers, those individuals earning more than $200,000 and couples earning $250,000 or more, will increase revenues to the U.S. Treasury. The empirical evidence suggests otherwise. None of the personal income tax or capital gains tax increases enacted in the post-World War II period has raised the projected tax revenues.

Over the past six decades, tax revenues as a percentage of GDP have averaged just under 19% regardless of the top marginal personal income tax rate. The top marginal rate has been as high as 92% (1952-53) and as low as 28% (1988-90). This observation was first reported in an op-ed I wrote for this newspaper in March 1993. A wit later dubbed this "Hauser's Law."

Over this period there have been more than 30 major changes in the tax code including personal income tax rates, corporate tax rates, capital gains taxes, dividend taxes, investment tax credits, depreciation schedules, Social Security taxes, and the number of tax brackets among others. Yet during this period, federal government tax collections as a share of GDP have moved within a narrow band of just under 19% of GDP.

Why? Higher taxes discourage the "animal spirits" of entrepreneurship. When tax rates are raised, taxpayers are encouraged to shift, hide and underreport income. Taxpayers divert their effort from pro-growth productive investments to seeking tax shelters, tax havens and tax exempt investments. This behavior tends to dampen economic growth and job creation. Lower taxes increase the incentives to work, produce, save and invest, thereby encouraging capital formation and jobs. Taxpayers have less incentive to shelter and shift income.

On average, GDP has grown at a faster pace in the several quarters after taxes are lowered than the several quarters before the tax reductions. In the six quarters prior to the May 2003 Bush tax cuts, GDP grew at an average annual quarterly rate of 1.8%. In the six quarters following the tax cuts, GDP grew at an average annual quarterly rate of 3.8%. Yet taxes as a share of GDP have remained within a relatively narrow range as a percent of GDP in the entire post-World War II period.



This is explained once the relationship between taxes and GDP growth is understood. Under a tax increase, the denominator, GDP, will rise less than forecast, while

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the numerator, tax revenues, will advance less than anticipated. Therefore the quotient, the percentage of GDP collected in taxes, will remain the same. Nineteen percent of a larger GDP is preferable to 19% of a smaller GDP.

The target of the Obama tax hike is the top 2% of taxpayers, but the burden of the tax is likely to fall on the remaining 98%. The top 2% of income earners do not live in a vacuum. Our economy and society are interwoven. Employees and employers, providers and users, consumers and savers and investors are all interdependent. The wealthy have the highest propensity to save and invest. The wealthy also run the lion's share of small businesses. Most small business owners pay taxes at the personal income tax rate. Small businesses have created two-thirds of all new jobs during the past four decades and virtually all of the net new jobs from the early 1980s through the end of 2007, the beginning of the past recession.

In other words, the Obama tax increases are targeted at those who are largely responsible for capital formation. Capital formation is the life blood for job creation. As jobs are created, more people pay income, Social Security and Medicare taxes. As the economy grows, corporate income tax receipts grow. Rising corporate profits provide an underpinning to the stock market, so capital gain and dividend tax collections increase. A pro-growth, low marginal personal tax rate stimulates capital formation and GDP, which triggers a higher level of tax receipts for the other sources of government revenue.

It is generally accepted that if one taxes something, one gets less of it and if something is subsidized one gets more of it. The Obama administration is also proposing an increase in taxes on capital itself in the form of higher capital gains and dividend taxes.

The historical record is clear on this as well. In 1987 the capital gains tax rate was raised to 28% from 20%. Capital gains realizations as a percent of GDP fell to 3% in 1987 from about 8% of GDP in 1986 and continued to fall to below 2% over the next several years. Conversely, the capital gains tax rate was cut in 1997, to 20% from 28% and, at the time, the forecasts were for lower revenues over the ensuing two years.

In fact, tax revenues were about $84 billion above forecast and above the level collected at the higher and earlier rate. Similarly, the capital gains tax rate was cut in 2003 to 15% from 20%. The lower rate produced a higher level of revenue than in 2002 and twice the forecasted revenue in 2005.

The Obama administration and members of Congress should study the record on how the economy reacts to changes in the tax code. The president's economic team has launched a three-pronged attack on capital: They are attacking the income group that is the most responsible for capital formation and jobs in the private sector, and then attacking the investment returns on capital formation in the form of dividends and capital gains. The out-year projections on revenues from these tax increases will prove to be phantom.

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