

Soak the Rich! Long live the Rich!

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There seems to be renewed interest to raise taxes on “the rich.” Depending on whom you ask, the definition of these “rich” generally begins around \$200,000 in annual income, which in today’s society is anything but rich. Doing very well, yes; But far from rich, particularly when at least half is taken for local, state, federal, employment and property taxes.

These chants to “soak the rich” are often preceded by an appeal to fund a particular benefit that is in jeopardy of being reduced due to a lack of tax money collected by the government. The claim is that if the “rich” would only pay more, then the increase in tax revenue could fund the benefit into the future.

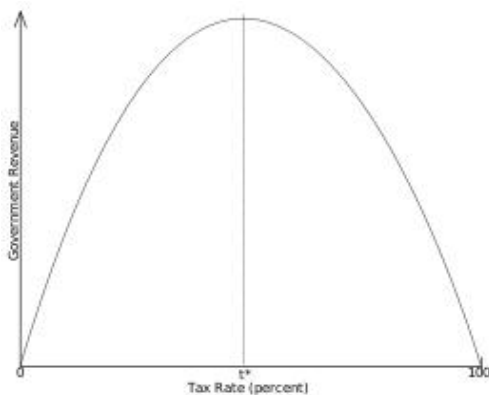
And while the “soak the rich” chant admittedly has a certain gut-level satisfaction embedded within it, the reality is that raising taxes on the “rich” does not necessarily increase tax revenues.

Counterintuitive? Yes. Unexpected? No. Here are two economic theories that have been proven historically to support my statement:

The Laffer Curve

Arthur Laffer, an American economist and member of President Ronald Reagan’s Economic Policy Advisory Board, theorized that tax rates and tax receipts do not move in a straight-line, linear relationship. That raising taxes by a certain percentage does not result in an increase in tax revenue by the same percentage, and could even lead to a decrease in revenue.

Laffer argued that there are two uncorrelated effects when tax rates are changed: arithmetic and economic. While the arithmetic effect is the more linear relationship, it is the economic effect, representing the positive and negative effects of tax rates on economic activity, that most influence the rate/revenue curve.

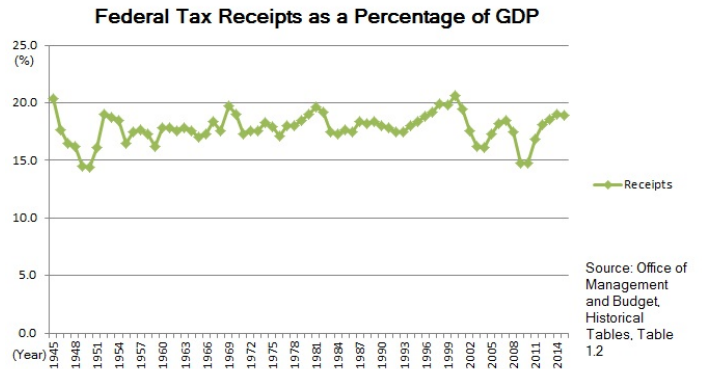


This tax rate/revenue relationship is best represented by a single-hump curve, the “Laffer Curve,” with its peak representing a tax rate that maximizes revenue. Both raising, and lowering, tax rates from this optimal point results in lower tax governmental receipts.

In the ‘80s he argued that the tax rate was on the downward slope of the curve, and that reducing the marginal tax rates would result in an increase in federal tax receipts. His theory proved to be true during both President Reagan’s and President Clinton’s second terms.

Hauser's Law

Nearly 20 years ago, the Hoover Institution's W. Kurt Hauser, published a report comparing federal tax receipts to Gross Domestic Product. The results of his analysis, recently reconfirmed and termed "Hauser's Law," demonstrates that there is a natural effective taxation limit of approximately 19%-20% of GDP. Raising taxes any higher than this limit does not lead to an increase in tax receipts.



The theory is that when taxes are raised above a certain level, taxpayers are more likely to take aggressive actions to limit their tax payments. They do this by either limiting current income (e.g., deferring income, not working as many hours), by taking advantage of tax preferences in the tax code (e.g., legal tax avoidance, gifting, "loopholes"), or by illegal misreporting of income and expenses.

The above theories are not simply unfounded ideas. They both have real world, historical support.

In my opinion, an attempt to increase tax revenues by raising tax rates is like pushing on a string. Even if I was to ignore the job-creation activities that upper-income earners and corporations supply (which is a huge thing for me to ignore), the only conclusion that I can come to is that raising tax rates will likely result in lower tax receipts.

The more prudent approach would be to reduce expenses to match revenue.