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QUICK STUDY

THE ROAD MAP TO TAX REFORM™

Summary: *Progressive taxation was designed to reduce income disparity by disproportionately taxing upper incomes and redistributing the proceeds through the welfare state. However, over the four decades, while the share of income taxes levied on the upper tenth of incomes rose 15 percentage points, the after tax income share of the remainder of incomes declined 13 percentage points. Progressive taxation has failed to reduce the disparity of real incomes.*

Does Progressive Taxation Redistribute Income?

By David A. Hartman

Since the Progressive Era of the early 20th century, the prevailing wisdom has been that progressive taxation of wealth is a necessary condition of social equity. This requires that the wealthy be taxed at increasing rates for increasing levels of income and assets. As a result, federal income taxes have risen from modest beginnings in 1913 to rates bordering on confiscation by mid-century.

Yet the maximum nominal federal income tax rates only show a portion of the marginal rates in composite. A dollar of salary income expended on consumption has a marginal rate equal to nominal. But a dollar saved and invested in a corporation must pay personal tax in order to be invested, corporate income tax before a dividend can be paid, and personal income on the dividend—a composite maximum marginal tax burden at 74.3 percent of the original income invested! Moreover, when inheritance tax is considered, only 11.6 cents of the original dollar earned now remains.

As the post-World War II boom subsided, it became apparent by 1960 that high marginal rates were causing economic stagnation, reduced savings and investments, and declining growth in jobs and incomes. The Kennedy tax cuts restored economic growth until the inflation of the '70s pushed incomes into higher brackets and slowed investment. While the Reagan tax cuts resumed economic growth, the 1993 marginal rate increased by President Clinton still far exceeds average rates on federal income taxes.

Over the course of the 20th century, the soaring revenues of the federal government enabled the growth of both welfare expenditures and income redistribution. The Great Depression and the Second World War resulted in broad welfare policies and highly progressive tax rates. When coupled with inflation and economic growth, the result has been a disproportionate escalation of tax revenues that have underwritten income distribution schemes without voter recourse. While the plurality of Americans perceived welfare as social insurance against disability or loss of livelihood, it's doubtful that the majority of voters ever embraced income redistribution.

Four Generations of Progressive Taxation

Whether or not progressive taxation has succeeded in increasing the real incomes of those of lesser means through the disproportionate taxing of the wealthier is the purpose of this study.

The top 10 percent of incomes reported on IRS returns was the group selected for this study as the most representative of progressive taxation levied upon income from physical and intellectual capital.

Over the period 1957–1971 the tax share paid by the top 10 percent was relatively constant, and the after-tax income of the other 90 percent of income was relatively constant as well as shown in Figure 1. Starting 1973 top 10 percent income tax share began a secular *rise* that continued through 1997, increasing from 48 percent to 63 percent. But contrary to the purpose of progressive taxation, the after-tax income of the other 90 percent commenced a corresponding secular *decline* from 72 percent to 59 percent.

The most revealing finding of Figure 1 is that *redistribution of the income tax burden and the proceeds of progressive taxation evidently had a negative effect upon the after tax income of those less affluent.* Simply stated, *as the tax share of the top 10 percent increased, the after-tax income share of the other 90 percent decreased–the opposite of the purpose of progressive taxation.*

Despite the increased tax burden shouldered by the top 10 percent and vast expansion of welfare to redistribute the increased income taxes collected, the after-tax income of other 90 percent declined. Both trends have continued to the present.

Interpretation of the Findings

The evidence presented is fact, but if a cause-and-effect relationship is to be proved, then it's imperative to dispel the possibilities of coincidental effects from alternative causes. Four questions must be addressed.

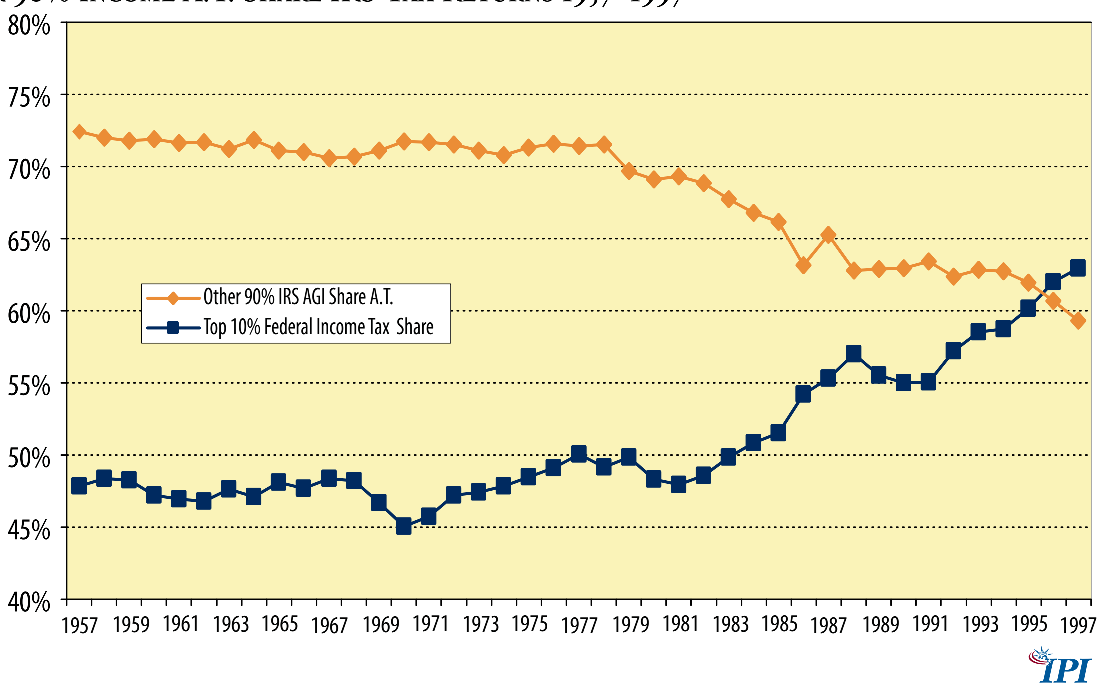
1. Is the result observed only an additional consequence of increasing inequality of income distribution resulting from disproportionate growth of the incomes of the wealthy?

In order to answer this question, we must compare the before-tax income of the top 10 percent of IRS returns with three others measures: mean income of the other 90 percent of IRS returns, median married couple total compensation, and mean income of the other 90 percent of personal income.

The average growth of top 10 percent mean income before FIT was virtually the same for the period 1957–1971 at 2.15 percent per year compared to 2.10 percent growth for the period 1971–1997. Whereas all three measures of other 90 percent significantly exceeded the growth of top 10 percent income during the 1957–1973 period when top 10 percent tax share was relatively constant, income growth was sharply reduced or nil for other measures of income from 1971–1997, the period of continuous rise of the top 10 percent tax share.

The decline of the other 90 percent income share clearly was not due to a disproportionate increase in the growth rate of the top 10 percent income. It was due to historically subnormal growth of the other 90 percent of incomes since progressivity of taxation resumed its secular increase.

Figure 1 **Top 10 % Tax Share vs. Other 90% Income A.T. Share IRS Tax Returns 1957–1997**



2. Did incomplete and/or misleading measures of lower incomes reported as AGI on IRS tax returns result in the observed relationship of the top 10 percent tax share versus the other 90 percent income share after tax?

There has been a declining trend of married couples families as a proportion of all families, particularly among those with lower incomes. However, marriage remains the typical status of the top 10 percent of IRS returns (88 percent in 1995). Also, AGI does not include certain government transfer payments. Do such deficiencies in the data account for the "income phenomena" observed?

This possibility was investigated by examining top 10 percent tax share versus the alternative measures of income after tax. *The correction for differences in family groupings and the inclusion of transfer payments and fringe benefits resulting from using NIPA personal income as the basis for other 90 percent income did not alter the findings shown earlier based solely upon AGI.*

3. Is there corroborating evidence that increasing the progressivity of income taxation has perverse effects upon incomes?

During the 1957–1997 period of study, there were four times when tax policy had directly observable changes in the average FIT rate on upper incomes, with consequent changes in all incomes. These occasions were: the Kennedy tax cuts of 1963, the hyperinflation of 1972–1981, the Reagan tax cuts of 1981, and the Clinton tax increases of 1993.

The effects of these changes in progressivity are examined in Table 1, comparing the significant changes in the average FIT rate on the top 10 percent of incomes with the changes in three measures of income growth before and after the changes in tax rate. The reduction of the top 10 percent FIT rates in 1963 and 1981 had the effect of promoting significantly higher income growth in the ensuing period than observed prior to the tax cut. The "bracket creep" during the hyperinflation of 1971–1981 severely reduced growth of incomes. Whereas the Clinton tax increases on the top 10 percent incomes appear to refute the 1971–1981 experience, the singular boom of the information sector has been hiding the perverse income effects. The laggard Old Economy and its ballooning trade deficit confirm grounds for concern.

Overall, the experience of the past 40 years shows *reducing marginal rates on financial and intellectual capital promotes income growth, whereas increasing marginal rates reduces income growth.*

4. Is progressive taxation based upon misconceptions as to the reality of the incidence of the tax burden?

Whatever the political intent, constructive or punitive, it would appear that the effect of the high marginal progressive rates of taxation on both human and intellectual capital is not as intended. *The evidence strongly suggests that the real income effects of high marginal taxation of financial and intellectual capital have resulted in lower real after-tax income for all*

Table 1 Change in Average Top Percent FIT Rate vs. Various Measures of Income Growth

Period		Top 10% Chg. Avg. Tax Rate	Top 10% Mean AGI Income BT	Other 90% Mean AGI Income BT	Median Married Compensation BT	Other 90% Personal Income BT
		(Constant 1996$)				
1963-1967 (Kennedy Cuts)	4 Yr % Change	-4.76%	+3.26%/Yr	**+2.88%/Yr**	+4.33%/Yr	**+3.59%/Yr**
	Prior 4 Yr % Chg	0.50%	+2.44%/Yr	**+2.24%/Yr**	+2.94%/Yr	**+2.44%/Yr**
1972-1981 (Stagflation)	9 Yr % Change	13.26%	+0.09%/Yr	**-1.24%/Yr**	+0.27%/Yr	**-0.171%/Yr**
	Prior 9 Yr % Chg	-3.56%	+2.07%/Yr	**+2.71%/Yr**	+3.56%/Yr	**+3.15%/Yr**
1981-1985 (Reagan Cuts)	4 Yr % Change	-15.43%	+3.92%/Yr	**+0.76%/Yr**	+1.42%/Yr	**+1.62%/Yr**
	Prior 4 Yr % Chg	-0.55%	+0.67%/Yr	**-0.85%/Yr**	-1.01%/Yr	**-1.28%/Yr**
1992-1996 (Clinton Increases Progressivety)	4 Yr % Change	13.85%	+2.61%/Yr	**-0.20%/Yr**	+1.16%/Yr	**+0.41%/Yr**
	Prior 4 Yr % Chg	-3.68%	-0.50%/Yr	**-0.53%/Yr**	-0.43%/Yr	**+1.18%/Yr**

NOTE: Total Personal Income (NIPA) less Top 10% AGI per household with same number adults per household as Top 10%.

Americans, and that more proportionate taxation should be adopted to promote economic efficiency—with equity of income distribution left to the impartial judgment of the markets.

Conclusions for Public Policy

Given that increasing the share of taxes paid by the wealthy does not increase the after-tax income of the remainder of the people, then serious reexamination of public policy is necessary. We are paying a high price for high marginal tax rates that limit domestic capital formation and income growth. Where are the offsetting benefits? What are the real costs incurred by punishing the productive and subsidizing the unproductive? What unwholesome behavioral and demographic trends are being promoted? Is the cruelest consequence an increasing tax wedge on financial and intellectual wealth whose cost is primarily borne by workers and consumers through lost jobs, lower incomes, and higher prices?

The fact that the hollowed institution of progressive taxation has not redistributed income cannot be ignored. The federal collection of progressive income taxes has corrupted definitions of the law and equity, and few will question that to a greater or lesser degree it is economically inefficient. It would seem that if it worsens rather than decreases disparity of income distribution, then only one realistic conclusion could follow: Progressive taxation for income redistribution has achieved the opposite of its objectives of helping persons of lesser means.

As for the third objective of progressive taxation—limiting the power of the wealthy—consider the power of the federal government today and recall what the excessive power of the state led to in Russia and Germany. Would not return of some of this power from the state to individuals better limit concentration of power and better secure our freedoms?

Progressive taxation is a demonstrated failure that demands remedy by fundamental tax reform. That tax reform should be rooted in an amendment to the Constitution of the United States as follows: No tax shall have more than one rate which shall be equally applicable to all taxpayers, and any deduction, exemption, or credit against a tax shall be equally beneficial to all taxpayers.

The result would be a return to the long-standing equity principle of civilized taxation adopted at the founding of the Republic: equality of taxation before the law through the principle of proportionality. Generous family credits for the taxes on basic necessities could prevent regressive hardship on those of lesser means.

Americans would find once again that poverty is best dispelled by growth-oriented public policies promoting a growing economic tide that raises all boats, not the unproductive misallocations of government largesse from confiscation of the efforts of our most productive citizens.

The Clinton tax reform of 1993, which increased progressivity of personal income tax rates, raised marginal rates and the tax wedge American goods and services must suffer in increasingly competitive world markets. The New Economy information market boom has masked the growing competitive disadvantage of the United States in the far larger Old Economy markets, as witnessed by the balance of trade hemorrhage.

As the loss of jobs and income has testified now that the New Economy capital investment boom has subsided, the case for fundamental tax reform has been clearly evident for decades.

This study is a summary of IPI Policy Report # 162, *Does Progressive Taxation Redistribute Income?* , by David Hartman, Chairman, The Lone Star Foundation.

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Editor & Publisher . . . . Tom Giovanetti

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